

STRATEGIC REGULATORY LANDSCAPE:

Regulatory Intent versus Policy and Market Risk in the Financial-Services Industry

Capital, Liquidity, Risk Management and Related Prudential Requirements



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Executive Summary

This analysis surveys the global and U.S. landscape of regulatory actions designed to improve safety and soundness, focusing only on prudential rules with strategic implications for global financial markets and the large financial-services firms on which they rely. The analysis was undertaken to answer two critical questions: how does each rule relate to all of the others and what is the sum impact in terms of preventing a repeat of the recent financial crisis? Regulators have readily acknowledged that they have yet to calculate this sum-total impact, agreeing that it is a vital unknown even as – pressed by new law, political demands and fear of inaction – they are finalizing substantive rules with far-reaching impact on the structure of financial markets, safety and soundness and the competitiveness of different types of financial-services firms and/or different national financial systems.

The goal of this survey is to examine the landscape of prudential rules and identify cross-cutting interactions and possible perverse consequences. This analysis recognizes that many of these standards are urgent repairs to financial-market regulation and financial-institution governance. However, because all of these rules are often crafted in “silos” in which regulators focus only on one issue or one nation, critical cross-cutting effects that may lead to unintended consequences are often not anticipated. Accordingly, key findings of the survey are not intended to argue that specific rules must be reversed; rather, they highlight regulatory interactions that warrant careful study at the top-tiers of regulatory and policy decision-making.

Importantly, this analysis is not an advocacy effort that selectively sampled rules or possible unintended effects. Rules selected for analysis represent a complete cross-section of major global and U.S. initiatives, with the desired intent for each determined by a review of each relevant document issued by the applicable governmental agency. The unintended effects and risks described in this landscape were determined following the review of a wide array of comment letters, regulatory speeches, policy-maker comments and other materials. The items chosen for presentation seek to present a fair sample of these views to make clear how far-reaching many pending regulatory initiatives may prove, not to argue that each risk will in fact result. In some cases, the intended benefit may well be worth the unintended risk, but this is a policy decision that cannot yet be made in an informed fashion because, prior to this analysis, there were no comparable cross-cutting analytics.

This strategic-analytical landscape does not attempt to assess each rule in detail as almost all of the rules analyzed here are extremely complex, a further impediment to an effective cross-cutting assessment. Overall, the detailed nature of many of these rules and their effort to define compliance under all circumstances for every covered entity creates an over-arching risk in the emerging regulatory framework. While much of this complexity derives from efforts to ensure rules are tightly drawn and to provide legal certainty, the very-detailed and prescriptive nature of many standards may in fact undermine compliance since it could prove impossible for board of directors, senior management and regulators to determine whether the new framework is indeed robust and having its desired effect.

To the extent very complex standards result in very detailed examination procedures that then permit protracted discussions between firms and supervisors over minor infractions, the new framework could well prove very fragile, especially under stress.

In addition to complexity, there are numerous other operational impediments to effective regulation germane to the landscape surveyed in this study. This includes problems related to sequencing rules so that predicate decisions – e.g., key definitions – are in place before the rest of a regulatory framework is constructed. Other impediments include varying accounting standards, differences between banks and nonbanks, conflicting regulatory actions germane to a single rule under multiple jurisdictions, and the lack of meaningful quantitative and qualitative analysis on a forward-looking basis of regulatory costs versus benefits. A separate study accompanying this one addresses these operational impediments in detail,¹ making clear how the absence of critical features of key rules – e.g., definitions, parameters of national versus extraterritorial enforcement – exacerbate complexity risk and increase the potential for unintended consequences.

In addition, this study is accompanied by another analysis of a critical question raised throughout this landscape: are an array of micro- and macro-prudential standards required because large banking organizations are still too big to fail?² If a taxpayer safety net is still suspended beneath financial-services firms, then some very tough rules, after due consideration of their sum total impact, may well be warranted. But, if even the largest financial-services firms cannot be rescued by taxpayers in ways that promote moral hazard and if rules appropriately limit contagion risk, then rules predicated on a safety net are counter-productive: they are unduly burdensome and contribute to the expectation that banks will again be bailed out. This final study assesses the U.S. orderly-liquidation authority constructed in the Dodd-Frank Act to bar taxpayer bail-outs, analyzing the law, pending implementation and critiques of these actions. The study highlights the untested nature and ongoing uncertainties surrounding the U.S. resolution regime, including the manner in which complex cross-border firms would be addressed. However, the analysis concludes that the U.S. regime constructs a formidable barrier to too big to fail through an express prohibition on taxpayer support and that necessary steps to settle uncertainties are already well under way.

¹ Federal Financial Analytics, *Operational Impediments to Effective Financial Regulation* (Oct. 2012), available at http://www.fedfin.com/images/stories/client_reports/operational%20impediments%20to%20effective%20financial%20regulation.pdf.

² Federal Financial Analytics, *Are SIFIs Still TBTF? An Assessment of the New Resolution Regime for Systemically-Important Financial Institutions* (Oct. 2012), available at http://www.fedfin.com/images/stories/client_reports/assessment%20of%20resolution%20regime%20for%20sifis.pdf.

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Introduction

Key Findings

This survey examines global and U.S. prudential regulations, focusing on those with strategic consequences for global financial markets and international financial institutions. The study comprehensively analyzes this prudential landscape to identify cross-cutting interactions and possible adverse outcomes. The fact that industry participants have objected to a regulation is not the basis of this survey, nor are only industry comments reflected in the description of possible unintended consequences. Ultimately, key findings of this survey do not show specific actions that must be reversed or advanced, but rather highlight regulatory interactions that warrant careful study by regulators and policy-makers.

Priority concerns include:

- **Capital and CCP Standards:** Pending global and U.S. capital rules appear to conflict with those demanded by the Group of Twenty (G-20) heads of state and many regulators that would convert as much over-the-counter (OTC) derivatives trading as possible into transactions on central counterparties (CCPs). Very costly capital requirements proposed for exposures to CCPs may make it difficult for banks in fact to execute this transition, leading either to continuation of OTC activities or sharp reductions in derivatives that could affect market liquidity and risk-hedging. The CCP capital charges could also promote boom-bust cycles (i.e., prove procyclical) because they ramp up dramatically under stress.
- **Capital Calculation:** Global and U.S. capital standards require consideration of unrealized gains and losses, intended to make capital more forward-looking. However, since these exposures are, by definition, unrealized, recognizing gains may artificially boost capital and doing the same for losses could make capital appear unnecessarily reduced. Since banks are subject to significant sanctions if they fall below well-capitalized levels (especially in the U.S.), many may maintain buffers well above those otherwise required, boosting capital to levels that could materially reduce credit availability and adversely affect economic recovery.

- **Capital and Liquidity Standards:** The proposed coverage of unrealized gains and losses may create a major conflict between global/U.S. capital standards and those being developed to address liquidity risk. The goal of the liquidity standards is to require large holdings of highly-liquid unencumbered assets, many of which are benchmark government bonds and similar obligations. These create significant balances of unrealized gains and losses since changes in interest rates unrelated to credit risk drive sometimes large variations in mark-to-market value. If capital varies related to these market changes, then it could be particularly difficult for banks to hold the assets required to prevent liquidity risk and/or to hedge the risks related to liquidity risk-reducing assets.
- **Credit-Exposure Limits and CCPs:** The FRB has proposed new rules that would significantly constrain single-counterparty credit exposures. Because the proposal does not exempt CCPs and is drawn so tightly, large banks – critical to the OTC derivatives market – would need to find many CCPs with which to do business to be able both to maintain their derivatives operations and use CCPs. However, no such capacity now exists, meaning that markets could be severely disrupted on at least a temporary basis.
- **Credit-Exposure Limits and Risk Mitigation:** A major goal of prudential regulation is to ensure that banks reduce risk through appropriate hedging operations. However, the proposed single-counterparty credit limits (SCCLs) noted above also fail to reflect many actions banks now take to hedge risk. If the proposed limits are not altered, then banks would be forced to choose between profit-making and risk-reducing exposures to large counterparties. Should they decide to reduce hedging, increased institutional and systemic risk could result.
- **Volcker Rule and Risk Mitigation:** The proposed “Volcker Rule” in the U.S. seeks to bar proprietary trading. However, its definitions may prove so complex and its penalties so stringent that banks may deem it too risky if they undertake hedging that regulators could potentially designate as proprietary trading. Banks could thus reduce hedging operations, again leading to an increase in an array of risks.
- **Shadow Banking:** All of the rules described above principally apply to banking organizations, although some may also govern nonbank financial companies determined to be systemically-important financial institutions (SIFIs). Regulators fear that the stringent nature of these rules could force many financial activities into the “shadow” sector – that is, un-

less-regulated firms that could create the next round of systemic risk. While acknowledging this concern and considering shadow-bank rules, none to date has been adopted in the global arena and U.S. rules are only beginning to take shape. This creates at least the near-term risk of migration of key financial activities outside the reach of U.S. or global regulators.

- **Bank vs. Nonbank Standards:** Reflecting this shadow-banking concern, the Dodd-Frank Act permits U.S. regulators to designate nonbank financial companies as SIFIs and, then, to subject them to Federal Reserve regulation. To date, the FRB has proposed SIFI standards, but these are largely based on its experience with banking organizations. These “bank-centric” rules may prove inapplicable to nonbanks, distorting their operations and/or contributing to the migration of financial services to shadow institutions.
- **Surcharge Standards and Orderly Resolution:** Many pending rules are premised on the view that large financial services firms may remain “too big to fail” (TBTF). As a result, capital surcharges may be required along with more stringent prudential standards. However, the Dodd-Frank Act includes a new orderly-liquidation authority (OLA) process that by law bars U.S. Government (USG) assistance for troubled financial firms, regardless of their size, unless the firm is an insured depository under the FDIC’s deposit-insurance system or subject to certain other, limited exceptions. Rules predicated on the continued existence of TBTF may undermine market understanding of the disciplines intended by OLA and, thus, fail to reverse anticipated bail-outs and resulting moral hazard. Expectations of TBTF could also permit large firms to grow still bigger since market discipline may be lacking, contributing to concentrations and other risks that undermine the objectives of post-crisis reform efforts.
- **Securitization:** The U.S. is planning to mandate that securitizers hold credit-risk positions for many assets sold into the secondary market, seeking better to align issuer and investor incentives. In concert with the new capital standards, these risk-retention requirements could undermine or even end the capital and balance-sheet management benefits that previously drove asset securitization, adversely affecting credit formation in key sectors. The law and pending rules would permit exceptions to risk retention if, for example, mortgage-backed securities are backed by the USG or government-sponsored enterprises (GSEs), and the combination of the cost of risk retention and these exceptions could force mortgage securitization only through USG and GSE channels, undermining current plans to return private capital to U.S. mortgage securitization.

- **Corporate Governance:** Many pending rules, especially in the U.S., require significant changes by boards of directors and senior management. These are intended to ensure high-level understanding and approval of strategic decisions and risk tolerances to ensure that policy and market-stability considerations are taken fully into account, not just short-term profit-making incentives. However, many pending standards are so complex as perhaps to undermine effective board and senior-management decision-making and to increase reliance on third parties with potential conflicts of interest. The complexity of these requirements could also make it more difficult for regulators to hold accountable directors and senior management.

Survey Methodology

The analysis was undertaken to answer two critical questions: how do each of these rules relate to all of the others and what is their sum impact in terms of preventing a repeat of the recent financial crisis. Regulators have readily acknowledged that they have yet to calculate this sum-total impact, agreeing that it is a vital unknown even as – pressed by new law, political demands and fear of inaction – substantive rules are being finalized with far-reaching impact on the structure of financial markets, safety and soundness and the competitiveness of different types of financial-services firms and/or different national financial systems.

This analysis is not premised on the view that each of the rules assessed here is wrong or unnecessary – quite the contrary. It recognizes that many of these standards are urgent repairs to financial-market regulation and individual-institution governance. However, because all of these rules are often crafted in “silos” in which regulators focus only on one issue or one nation, critical cross-cutting effects that may lead to unintended consequences are often not anticipated and, thus, addressed before they occur.

This strategic regulatory landscape seeks to advance policy understanding on these vital issues by correlating new and pending prudential rules to assess their intended impact and possible unintended effect – frequently counter-productive to precisely these desired effects. Importantly, this analysis is not an advocacy effort that selectively sampled rules or possible unintended effects. Rules selected for analysis represent a complete cross-section of major global and U.S. initiatives, with the desired intent for each determined by a review of each relevant document issued by the applicable governmental agency. The unintended effects and risks described in this landscape were determined following the review of a wide array of comment letters, regulatory speeches, policy-

maker comments and other materials. The items chosen for presentation seek to present a fair sample of these views to make clear how far-reaching many pending regulatory initiatives may prove, not to argue that each risk will in fact result. In some cases, the intended benefit may well be worth the unintended potential risk, but this is a policy decision that cannot yet be made in an informed fashion because, prior to this analysis, there were no comparable cross-cutting analytics.

This strategic-analytical landscape does not attempt to assess each rule in detail as almost all of the rules analyzed here are extremely complex, a further impediment to an effective cross-cutting assessment. To facilitate this survey, an initial discussion presents key aspects of each initiative and its status, followed by key aspects of each rule and a short presentation of its identified and unintended consequences. Overall, the detailed nature of many of these rules and their effort to define compliance under all circumstances for every covered entity creates an over-arching risk in the emerging regulatory framework. While much of this complexity derives from efforts to ensure rules are tightly drawn and to provide legal certainty, the very-detailed and prescriptive nature of many standards may in fact undermine compliance since it could prove impossible for boards of directors, senior management and regulators to determine whether the new framework is indeed robust and having its desired effect. To the extent very complex standards result in very detailed examination procedures that then permit protracted discussions between firms and supervisors over minor infractions, the new framework could well prove very fragile, especially under stress.

In addition to complexity, there are numerous other operational impediments to effective regulation germane to the landscape surveyed in this study. This includes problems related to sequencing rules so that predicate decisions – e.g., key definitions – are in place before the rest of a regulatory framework is constructed. Other impediments include varying accounting standards, differences between banks and nonbanks, conflicting regulatory actions germane to a single rule under multiple jurisdictions, and the lack of meaningful quantitative and qualitative analysis on a forward-looking basis of regulatory costs versus benefits. These issues are also noted in this paper, generally with regard to possible unintended consequences. They are discussed in more detail in a parallel analysis of each of these operational impediments and their effect across the landscape as a whole.

Capital and Liquidity

Basel III Capital Regulation

The global Basel III capital standards were finalized in December 2010 and are now being implemented in many nations, including the United States. The rules revise the Basel II Accord largely by redefining the numerator of capital and increasing the amount of it that must be held against risk-weighted assets (RWAs). In general, capital must now be largely comprised of tangible common equity and reach a “Common Equity Tier 1” ratio of 4.5% against RWAs. RWAs are changed in Basel III principally with respect to complex assets, otherwise leaving the Basel II framework intact, but a new global leverage standard requires that on- and off-balance sheet assets regardless of risk weighting be backed by 3% Tier 1 capital.

Issue	Intended Impact	Possible Unintended Impact
Macroeconomic Impact	Gradual implementation until 2019 to ensure that rules do not undermine economic recovery	<ul style="list-style-type: none"> • Market forces/regulators require more rapid compliance with fully phased-in Basel III, leading to significant balance-sheet restructuring, deleveraging, risk to macroeconomic recovery/key sectors (e.g., housing)
Global Framework	Create consistent capital framework that ensures sound banking and prevents regulatory arbitrage/risky competitive advantage	<ul style="list-style-type: none"> • Lack of consistent standard/implementation leading to divergent national capital regimes, as determined by the Basel Committee peer review process
“Hard” Equity Regulatory Capital	Provide resilient form of risk-absorption	<ul style="list-style-type: none"> • Requirement to deduct unrealized gains/losses creates capital volatility without resulting improvement in capital bulwark • Limited recognition of mortgage servicing rights (MSRs) undermines secondary-mortgage market recovery

Issue	Intended Impact	Possible Unintended Impact
Risk Weighting of Assets	Capital incentives to hold only low-risk assets	<ul style="list-style-type: none"> • Regulatory arbitrage/competitiveness problems because national practices differ widely on risk weightings • Strong incentive to hold only sovereigns (most zero weighted), reinforcing link between banks and taxpayers, undermining lending
Counter-Cyclical Buffer	Impediment to boom/bust cycles	<ul style="list-style-type: none"> • Based on unproven macroprudential measure • Subject to significant differences in national implementation • Duplicative of conservation buffer (also aimed at counter-cyclicality)
Capital-Conservation Buffer	Ensure capital adequacy even under strain	<ul style="list-style-type: none"> • Additive to stress-test capital standards, prompt corrective action in U.S., which effectively creates a third layer of regulatory capital, increasing risk of adverse macroeconomic impact
Accounting Standards	Harmonize accounting standards to permit comparable Basel III implementation across national regimes	<ul style="list-style-type: none"> • Wide divergence in applicable accounting results in significant disparities in actual Basel III impact (e.g., regarding “reserve,” “equity,” other key definitions)

U.S. Basel III Rules

The FRB, OCC and FDIC have proposed not only the U.S. version of the global Basel III capital rules for the banking book, but also a general rewrite of U.S. regulatory-capital standards for insured depositories and their holding companies. The proposal would track most aspects of the global standards by requiring reliance on tangible common equity in larger amounts to ensure a bank is “adequately” capitalized. However, U.S. rules would depart from the global ones by mandating a tougher definition of eligible capital, setting higher minimum “floors” (due to the Collins Amendment in Dodd-Frank) and deleting ratings references in favor of what is generally a more stringent way to judge credit risk. The proposal also departs from the global rules by rewriting the RWA standards for several asset classes, including residential mortgages. U.S. banks that fall below specific capital levels would be subject to stringent prompt corrective action (PCA). Additional disclosures would be required under strict new governance standards including board approval and senior-management attestation.

Issue	Intended Impact	Possible Unintended Impact
Macroeconomic Impact	Promote stable banking system that enhances durable growth	<ul style="list-style-type: none"> • Cost of capital may rise so high that recovery choked off, specific sectors (e.g., mortgages) see sharp drops in credit availability
Global Standards	Bring U.S. into compliance with global regulatory-capital regime	<ul style="list-style-type: none"> • U.S. standards more stringent, creating competitiveness, barrier-to-entry concerns • Other nations may not impose RWAs with the same rigor, creating appearance of global framework without actual implementation • U.S. minimum floor exacerbates level playing field disparities

Issue	Intended Impact	Possible Unintended Impact
Application to Non-Traditional Firms	Impose uniform framework for BHCs/S&LHCs	<ul style="list-style-type: none"> • Capital regime inappropriate for S&LHCs principally engaged in insurance or other nonbanking activities, with bank-centric rules imposing unnecessary standards likely to disrupt insurance operations, product cost/availability • Departs from “functional” regulatory standards where FRB generally defers to primary regulator of subsidiaries
Leverage Requirement	Ensure adequate capital regardless of RWAs	<ul style="list-style-type: none"> • Simple leverage requirements may create incentive for risk arbitrage, concentrated holdings in high-risk positions given low risk weightings (e.g., USG obligations with interest-rate, other risk)
Eligible Capital	Permit only robust equity to count as capital	<ul style="list-style-type: none"> • Exclusion of possible risk-absorbers (e.g., certain “hybrids”) unduly limits eligible capital for small institutions without efficient capital markets access • Differences between U.S./Basel rules raises competitiveness, barrier-to-entry concerns
Capital Floors	Prevent undue reliance on models	<ul style="list-style-type: none"> • Creates disincentive to risk mitigation/hedging as floors do not capture true risk of many instruments
Capital Calculation	Reflect real risk by excluding from capital unrealized gains/losses	<ul style="list-style-type: none"> • Creates disincentive for banks to hold low-risk assets (e.g., U.S. Treasury obligations) necessary to meet the liquidity rules • Artificial fluctuations in capital that could lead to PCA sanctions • Volatile capital ratios that disrupt markets as banks increase/decrease credit due to short-term changes not germane to risk • May present artificially rosy view of capitalization due to recognition of unrealized gains

Issue	Intended Impact	Possible Unintended Impact
Capital-Conservation Buffer	Ensure adequate capital even under stress	<ul style="list-style-type: none"> • Conflicts with other requirements (e.g., stress tests) • Restrictions on “discretionary” bonuses if buffer is breached could lead to more reliance on contractual bonuses, counter to desired improvements in incentive compensation mandated in other U.S., global rules
Counter-Cyclical Buffer	Impose capital add-on to prevent boom-bust cycles, limit systemic risk	<ul style="list-style-type: none"> • Based on unproven measures • U.S. proposal differs from global buffer and thus raises impact/competitiveness concerns • Application only to largest banks imposes new surcharge in addition to Basel G-SIB surcharge
Sovereign/Similar Obligations	Define credit risk without reference to ratings	<ul style="list-style-type: none"> • Use of unproven credit-risk measures undermine transparency, comparability, create risk-arbitrage incentives • Favorable treatment of U.S. obligations poses liquidity/cost concerns for high-quality sovereign issuers, protectionist concerns
Residential Mortgages	New risk weightings to reflect mortgage credit risk	<ul style="list-style-type: none"> • May over-correct for problems in crisis and potential qualified-mortgage/risk-retention rules (separate initiatives designed to ensure prudent product and securitization characteristics) • Loan-to-value criteria create penalty for first-time, low/moderate income buyers that discourage bank loans and create strong incentive for use only of FHA/GSE securitization • Incentives remain for risky securitizations to the USG/GSEs • Disincentive for loan modifications

Issue	Intended Impact	Possible Unintended Impact
PCA	Ensure rapid supervisory action when capital falters	<ul style="list-style-type: none"> • Different standards than under current capital stress tests, proposed under FRB early-remediation requirements, creating potential conflicts/confusion for supervisors and banks, undermining transparent sanctions when overall safety and soundness is threatened
Treatment of Securities Firms	Reflect perceived risk differential between banks and securities firms	<ul style="list-style-type: none"> • Fails to reflect regulatory framework, other rules governing securities firms, promotes reliance only on banks with market-distorting impact
OTC Derivatives	Boost risk-based capital (RBC) for exposures	<ul style="list-style-type: none"> • Netting, other risk mitigants in OTC derivatives may not be well recognized, especially since the standardized approach sets advanced-approach floor
Central Counterparties (CCPs)	Encourage use of CCPs	<ul style="list-style-type: none"> • Sharp hikes in RBC as conditions change at CCPs could create extreme market volatility under stress, high capital requirements for clearing member exposure to CCP default funds, discourage reliance on CCPs in contrast to regulator/G-20 goals • Treatment of clearing member bank's exposure to clients as bilateral OTC derivatives may create disincentive to clear for clients, inconsistent with G-20 goals
Credit Risk Mitigation	Provide capital incentives for real credit risk transfer	<ul style="list-style-type: none"> • Limitations undermine proven, capitalized risk hedges (e.g., credit default swaps, monoline bond/mortgage insurance), with failure to recognize this exacerbating possible macroeconomic, sector impact of limited credit availability

Issue	Intended Impact	Possible Unintended Impact
Disclosures	Promote market discipline	<ul style="list-style-type: none"> • May require covered firms to disclose proprietary/confidential information, possibly so frequently as to confuse markets, distract from material events • Legal/reputational risk resulting from possible conflict with securities-law requirements

Trading Book Fundamental Review

Although the U.S. has only now finalized the Basel 2.5 reforms to the regulatory-capital standards governing big-bank trading books, the Basel Committee has proposed a wholesale rewrite of this regime. Among the most significant changes would be replacement of the current value-at-risk (VaR) methodology (strengthened in Basel 2.5) with an “expected shortfall” (ES) approach for measuring the risk taken in an array of bank activities in the capital markets. The fundamental rewrite also builds on Basel 2.5’s effort to limit arbitrage between the banking and trading books by redefining assets that come under the newly-stringent market-risk capital standards.

Issue	Intended Impact	Possible Unintended Impact
Trading-Book Risk Reduction	Ensure that sophisticated trading/investment activities are backed by ample capital	<ul style="list-style-type: none"> • Duplicative of other efforts (e.g., Volcker, Vickers, Liikanen Committee) to limit these risks through prohibitions/ring-fencing, creating undue burden for remaining activities and encouraging transfer of bank capital-market operations to “shadow” firms • Increased concentration of bank positions creates market correlation risk
End to VaR	Improve risk sensitivity and capital resilience, in part by standardizing ES measures to limit risk	<ul style="list-style-type: none"> • ES is model-driven, untested and may be based on incomplete data • New model also poses supervisory, implementation challenges that could hike risk, at least in near-term
Liquidity Time Horizons	Limit trading-book risk resulting from liquidity stress	<ul style="list-style-type: none"> • Time horizons longer than usual in market or experienced under stress • Requires larger holdings of eligible liquid assets that increase funding costs and capital requirements, possibly to detriment of efficient capital markets

Issue	Intended Impact	Possible Unintended Impact
Banking/Trade Book Boundaries	End arbitrage	<ul style="list-style-type: none"> • Brings many banks without large trading books under costly, complex capital rules
Standardized Approach	Limit model reliance	<ul style="list-style-type: none"> • Increased bank/market correlation since risk treated the same, reduced incentives for low-risk holdings

U.S. Basel 2.5 Rule

The Basel 2.5 rule governs market risk-based capital – that is, regulatory capital that must be held against risks in the trading book (with the Basel III framework otherwise applicable to credit and certain related risks in the banking book). The U.S. version of the Basel 2.5 framework, like the global one, continues largely to base market-risk capital on VaR measures, although these are now subject to stress tests and other requirements designed to make the regime more robust under stress. The new standards also seek to make it harder for banks to move assets between the banking and trading books. However, departing from the global framework, the U.S. Basel 2.5 rule does not rely on credit ratings, doing so in compliance with the Dodd-Frank requirement that references to ratings be deleted from U.S. financial regulation.

Issue	Intended Impact	Possible Unintended Impact
Implementation	Ensure more robust trading-book capital in near term	<ul style="list-style-type: none"> • Confusion and lack of accountability because Basel 2.5 is mandated even as global regulators propose a “fundamental rewrite” of these rules to delete VaR and make other far-reaching changes
Trading- vs. Banking-Book Capital	Ensure risk is capitalized at all times	<ul style="list-style-type: none"> • Duplicative requirements that mandate both trading- and banking-book capital for the same risk, unnecessarily curtailing prudent trading and hedging activities
Ratings Elimination	Objective, transparent credit-risk judgments by banks that avoid “cliff effects,” errors resulting from credit rating agency (CRA) reliance	<ul style="list-style-type: none"> • Replacement of CRAs with untested alternatives • Sovereign weightings particularly problematic due to reliance on OECD scale designed for export-finance, not credit risk • Sovereign weightings drive others (e.g., for banks), thus compounding the lack of risk sensitivity

Issue	Intended Impact	Possible Unintended Impact
Capital Floors	Ensure minimum capital to counter stress, model weakness	<ul style="list-style-type: none"> • Capital incentive to hold riskier positions, since floor eliminates benefit of lower-risk assets
Treatment of Securitization Exposures	Ensure robust standards reflecting asset-backed securities (ABS) performance under stress	<ul style="list-style-type: none"> • Higher market-risk charges could reduce investor demand for ABS such as residential mortgage-backed security MBS (RMBS), adversely affecting cost and credit availability in affected sectors • Favorable treatment of USG/GSE MBS could block return of private capital • In concert with the Volcker Rule, an effective ban on proprietary trading except for USG obligations could result

Basel III Liquidity Standards

In tandem with finalizing global capital standards, Basel regulators in 2010 issued sweeping new liquidity-risk requirements. These are intended to protect banks from short-term stress resulting from frozen financial markets or fears about a specific bank. Historically, bank emergency liquidity needs have been met by central banks like the Federal Reserve. However, the new global liquidity standards are designed to force banks first to address this risk by holding better-matched books of unencumbered highly-liquid assets to limit the risk resulting from large central-bank draws or failures that could otherwise be averted. The Basel III liquidity standards include a liquidity coverage ratio (LCR) designed to ensure resilience over 30 days and a net stable funding ratio (NSFR) covering one year. Eligible liquid assets are defined largely to cover only sovereign obligations and banks must hold enough of them under run-off and draw-down scenarios detailed in the rule to achieve 100% LCR/NSFR. The rules are currently in an “observation period,” during which regulators have determined that aspects of the LCR pose problems, which they intend to remedy with revised standards by year-end 2012 at the earliest. The NSFR remains in many ways incomplete, although regulators still expect it to be in place by 2018.

Issue	Intended Impact	Possible Unintended Impact
Global Framework	Establish common international standards that protect global markets, ensure competitive equity	<ul style="list-style-type: none"> • Divergent national implementation results in wide variance and potential arbitrage
Eligible Assets	Ensure only cash-like assets count for purposes of the ratios	<ul style="list-style-type: none"> • The definition of unencumbered highly-liquid assets focuses principally on sovereign obligations, increasing reliance on bonds that can in fact pose significant liquidity risk, exacerbate vicious cycles of sovereign instability (e.g., EU crisis) • Global definitions do not reflect national circumstances (e.g., role of GSEs and Federal Home Loan Banks in the U.S.), thus forcing still more reliance on sovereign issuances and creating obstacles to liquid markets in key areas (e.g., mortgages)

Issue	Intended Impact	Possible Unintended Impact
LCR/NSFR Methodology	Ensure greater financial-market liquidity under stress	<ul style="list-style-type: none"> • Prescriptive models used by regulators are based on global criteria not applicable in some nations and research that has only begun to assess causes of liquidity crises
Disclosures	Promote market discipline through greater investor/counterparty insight into bank liquidity positions	<ul style="list-style-type: none"> • Lack of standardized models/assumptions, especially across borders, creates misleading disclosures • Monthly reporting requirements could create incentives for the timing of payment transactions

U.S. Liquidity Standards

Although global regulators finalized new bank liquidity standards at the end of 2010, these have yet to be proposed in the U.S. This delay in part results from problems identified with the global standards regulators hope to resolve by year-end 2012 at the earliest. However, even though basic liquidity standards remain in the works in Basel and are not yet released in the U.S., the FRB has proposed a comprehensive liquidity framework for all bank holding companies with assets over \$50 billion to meet the systemic-regulatory requirements of Section 165 of the Dodd-Frank Act. The law requires that these standards also cover systemic nonbanks, but the FRB’s proposal does not make clear how this will be done. In general, all of these liquidity rules set time horizons and, based on models related to liquidity draws and stress scenarios, require banks to hold ample unencumbered liquid assets to offset shocks such as those that, as in the Lehman case, were evident in the financial crisis and now grip the European Union.

Issue	Intended Impact	Possible Unintended Impact
Liquidity-Risk Framework	Rapid establishment of U.S. standards for systemic firms	<ul style="list-style-type: none"> • Incompatible U.S. requirements pose arbitrage/competitiveness concerns • Undue cost for large U.S. BHCs because rules may need rewrite after overall standards finalized • Possible migration to shadow banks not covered by liquidity-risk rules
Bank/Nonbank Coverage	Address known risks now and defer action on nonbanks	<ul style="list-style-type: none"> • Promotes flight to shadow banks except to extent nonbanks declared systemic • FRB standards are so bank-centric as to be inapplicable to nonbanks, resulting in perverse consequences absent development of separate, targeted framework

Issue	Intended Impact	Possible Unintended Impact
Liquid Assets	Ensure sufficient holdings of truly unencumbered liquid assets to meet needs, especially under stress	<ul style="list-style-type: none"> • Broader possible U.S. definition than Basel to date avoids wholesale focus on sovereign and similar assets, which would have significant risk (e.g., concentrated bank positions in risky sovereigns) • Rules still do not reward banks for holding assets with proven liquidity and has undue favorable treatment only for the U.S. regarding sovereign risk, adding balance-sheet risk that forces more capital, especially if risks related to holding liquid assets are appropriately hedged. The more a bank holds assets to handle liquidity, the higher its regulatory capital requirements related to these assets • No exemption provided for these assets in the capital rule to address this conflict even if liquid assets held to ensure full participation in the CCPs being required by Dodd-Frank/global rules to reduce derivatives-trading risk
Corporate Governance	Ensure board/senior management govern liquidity-risk tolerances, validate models	<ul style="list-style-type: none"> • Detailed review/approval standards, especially for the board, require such detailed consideration that the boards may still rely unduly on line-unit representations, undertake unnecessary/inappropriate management responsibilities to ensure all detailed approvals are granted in an informed fashion • Granularity of governance requirements could lead management to focus on details of the rule, not actual bank risk
Liquidity Ratios	LCR to ensure ample liquidity over a 30-day period, including under stress	<ul style="list-style-type: none"> • 30-day threshold is arbitrary and liquidity risk often occurs between this period and the one-year threshold pending in the global rules (NSFR) • Granular requirements not substantiated by research on liquidity risk (far less done by regulators here than on capital)
Stress Scenarios	Ensure ample LCR even under acute stress	<ul style="list-style-type: none"> • Requirement that systemic banks hold more than the LCR to handle stress means rule will be unduly costly • Global standards to permit maximum ratio to include a buffer so banks may fall below when under stress scenario

G-SIB Surcharge

The Basel Committee has issued final standards to impose a capital surcharge on global systemically-important banks (G-SIBs). The surcharge is intended to charge designated banks for potential taxpayer “bail-out” and/or for the macroeconomic cost of their failure. Global regulators have agreed under pressure from G-20 finance ministers that similar surcharges are required for nonbank global systemically-important financial institutions (G-SIFIs), but the methodology for designating such entities and the surcharges that might then apply have yet generally to advance. The Basel Committee has now also issued proposed principles to impose capital surcharges for domestic systemically-important banks (D-SIBs), that is, banks that are not G-SIBs but that still pose systemic risk in specific jurisdictions. The Dodd-Frank Act requires that U.S. bank holding companies with assets over \$50 billion meet capital-surcharge standards, and the FRB’s pending systemic proposal indicates that U.S. BHCs designated as G-SIBs would be required to hold still more capital, although the amount of any of these surcharges is uncertain. The law also mandates a surcharge for nonbank SIFIs designated as such by the Financial Stability Oversight Council (FSOC), but rules on how to designate these SIFIs have only now been finalized and the FRB has indicated that it will consider SIFI surcharges once it has finalized the large BHC ones.

Issue	Intended Impact	Possible Unintended Impact
G-SIB Goal	Penalize designated firms for being too big to fail (TBTF) and posing too much risk to macroeconomy	<ul style="list-style-type: none"> • Unnecessary in light of other U.S. law preventing TBTF, living wills and other rules limiting macroeconomic impact of large-bank failure, thus reinforcing the view that big banks are in fact TBTF and promoting moral hazard • Global methodology does not reflect different resolution regimes (some provide for TBTF, others, like U.S., do not)
Macroeconomic Impact	Require significant capital at G-SIBs without limiting credit availability, growth	<ul style="list-style-type: none"> • Designated banks bear so large a capital burden/play so large a role in key markets that capital charges may in fact adversely affect credit availability and recovery

Issue	Intended Impact	Possible Unintended Impact
Coverage	Start surcharges with G-SIBS, but progress to G-SIFIs	<ul style="list-style-type: none"> • Continued uncertainty, opposition to G-SIFI surcharges means capital charges effective only for banks, encouraging shift to “shadow” sector, less regulated firms in parallel products
Bank Designation	Reflect TBTF, other benefits	<ul style="list-style-type: none"> • Creates incentive for “shadow” financial institutions exempt from G-SIFI surcharge, other regulatory requirements
Criteria	Identify banks that pose risk based on diverse factors	<ul style="list-style-type: none"> • Research still uncertain regarding what in fact creates systemic risk • Basel notes data to measure factors often unavailable, making designation still subjective in key areas • Ambiguities mean G-SIB designation may be result of negotiation among regulators protecting banking systems • Banks scaled against each other within G-SIB class so that risk reduction does not necessarily mean drop in surcharge (perverse incentive to take risk)
Candidates	Identify possible G-SIBs with objective criteria across different banking systems, resolution protocols	<ul style="list-style-type: none"> • Much in G-SIB methodology based on supervisory judgment, qualitative criteria • Rigor of national regulation/resolution protocol not factored
Methodology	Raise surcharge as systemic risk posed by G-SIB increases	<ul style="list-style-type: none"> • Basel rule notes that much is “arbitrary” • Methodology/data even more uncertain regarding individual banks, especially with regard to comparable cross-border measurement

Issue	Intended Impact	Possible Unintended Impact
U.S. Designation	Name G-SIBs as designated by Basel Committee	<ul style="list-style-type: none"> • Global standards name banks that do not clearly meet criteria (e.g., one lacks international operations cited as global designation criteria) • Subjective designation and/or based on size (not meaningful systemic factor, as regulators acknowledge)

Domestic Systemically-Important Banks

In addition to mandating capital surcharges for G-SIBs, the Basel Committee has proposed similar add-on requirements for domestic systemically-important banks (D-SIBs). However, unlike the G-SIB standards, those proposed for D-SIBs leave the methodology by which these banks are selected and the capital that would then apply to them largely to national discretion. The comment period closed on this proposal on August 1, with the Basel Committee planning to require these surcharges on the same schedule finalized for G-SIBs (that is, starting in 2016).

Issue	Intended Impact	Possible Unintended Impact
Too Big to Fail	Charge banks for benefit of TBTF and/or cost to national economy of failure	<ul style="list-style-type: none"> • Creates continued expectation of TBTF; direct conflict with U.S. OLA
Macroeconomic Impact	Do not undermine economic growth	<ul style="list-style-type: none"> • Add-on capital charge to already stringent Basel III standards could increase risk of reduced credit availability, concentration in low RWAs that do not support economic growth or recovery • Small nations that impose D-SIB surcharges on large international banks could see banks exit, resulting in significant reduction in credit availability, other financial services and/or reduced national-market efficiency and competitiveness
Treatment of Banks	Capture high-risk institutions	<ul style="list-style-type: none"> • Creates incentive to conduct financial activities outside banking charter, especially for large institutions subject to Basel III, G-SIB/D-SIB surcharges

Issue	Intended Impact	Possible Unintended Impact
Global Framework	Uniform international standards to identify, impose surcharge on D-SIBs	<ul style="list-style-type: none"> • Lack of clear criteria could create widely different D-SIB designation/surcharge requirements that impose barriers to entry, national-treatment and competitiveness concerns • Basel peer-review process designed to harmonize national standards has uncertain impact (prior peer reviews have not substantially altered national practice regardless of wide variations from Basel rules)
Integration of Surcharge Requirements	Require banks to hold higher of applicable G-SIB/D-SIB surcharges	<ul style="list-style-type: none"> • Could lead to very high U.S. capital charges for the largest banks due to stringent nature of U.S. rules, uncertain relationship of D-SIB requirements with pending Basel III standards and rules for BHCs with assets over \$50 billion
Treatment of Branches	Require D-SIB surcharges only on host-country subsidiaries	<ul style="list-style-type: none"> • Creates capital incentive to engage in international operations through branches, not subsidiaries, possibly increasing complexity/orderly-resolution risk, supervisory impediments to needed information in home countries
Nature of Capital Surcharge	Impose an added layer of loss absorbency	<ul style="list-style-type: none"> • Variations in capital regimes (e.g., application of buffers, use of varying Basel III standards or none at all, additional stress-test requirements as in the U.S./U.K.) may result in widely varying D-SIB surcharges
Non-Capital D-SIB Requirements	Allow supervisors to impose non-capital standards to D-SIBs	<ul style="list-style-type: none"> • Wide variations in additional D-SIB requirements could further undermine goal of global harmonization, increase competitive/barrier-to-entry concerns

U.S. Stress Tests and Capital Planning

Starting in 2009, the Federal Reserve has mandated stress tests of the largest U.S. banks to determine their capital resilience under increasingly stringent stress scenarios. These requirements were codified in a final 2011 FRB rule on capital plans and are also pending in stress-test standards proposed by the FRB, FDIC and OCC to comply with requirements of the Dodd-Frank Act. If a banking organization does not pass these stress tests, its ability to make capital distributions (e.g., dividends) is curtailed and it may come under additional supervisory sanction.

Issue	Intended Impact	Possible Unintended Impact
Stringency	Under comparable criteria, determine the ability of banks/BHCs to remain well capitalized even under seriously-adverse scenarios	<ul style="list-style-type: none"> • Scenarios used to date by FRB are not disclosed to ensure BHCs run tests appropriately, show resilience under applicable conditions to individual firms
Focus on Capital	Test key safety-and-soundness criterion	<ul style="list-style-type: none"> • Does not clearly ensure resilience under other stress (e.g., liquidity, operational) • Does not address key governance issues beyond capital planning
Macroeconomic Impact	Ensure capital resilience without adverse impact on credit availability	<ul style="list-style-type: none"> • Higher capital may lead banks to reduce credit availability, especially in sectors subject to higher risk-based capital requirements
Governance	Require boards to ensure capital-plan compliance	<ul style="list-style-type: none"> • Possible contradiction of board responsibilities if stress tests do not in fact relate to actual risk at BHCs • Force withdrawal of capital distributions necessary to attract capital to support recovery/growth • Possible conflicts between capital stress tests and living-will stress tests

Issue	Intended Impact	Possible Unintended Impact
Capital Distributions	Ensure capital is husbanded for shock absorption	<ul style="list-style-type: none"> • Models may be inapplicable to nontraditional BHCs, reducing financial-industry efficiency • Unclear how stress tests would apply to systemic nonbanks, perhaps creating unnecessary disruption, loss of market capitalization due to investor fears even at resilient firms
Stress-Test Models	Rigorous, forward-looking stress tests	<ul style="list-style-type: none"> • Built on untested models that can lead to regulatory sanction even when a BHC “fails” by only a few basis points
Relation to Other Requirements	Ensure a clear stress-test measure of capital resilience	<ul style="list-style-type: none"> • Comes in combination with new capital-conservation/counter-cyclical buffer, creating conflicting test standards if all of these are additive • Burdensome capital with macroeconomic, competitiveness impact
Investor Interests	Stress tests designed in part to promote investor interest in BHCs by transparent demonstration of resilience	<ul style="list-style-type: none"> • Dividend uncertainty at large BHCs reduces investor appetite, resulting in lower market capitalization, more risk • No demonstrated link to date between higher regulatory capital and lower cost of equity

International Stress Tests and Capital Planning

The U.S. has to date taken the lead in implementing stress tests for banking organizations and mandating capital-distribution restrictions based on stress-test results. However, the U.K. is undertaking new stress-test standards in concert with broader FSB efforts to require living wills to ensure orderly resolution even under seriously-adverse stress. The European Banking Authority (EBA) began to mandate stress tests as the EU financial crisis worsened, but the test did not reflect either forward-looking risk (now realized in the Eurozone) or vulnerabilities in the capitalization of many banks that had large holdings in EU sovereign obligations. The EBA in 2011 revised its stress test and increased its stringency, implementing temporary capital ratios at higher levels that are now likely to be mandated as a floor for EU capital even as the Basel III rules are implemented in the ongoing transition period.

Issue	Intended Impact	Possible Unintended Impact
Global Framework	Harmonized stress-test standards	<ul style="list-style-type: none"> • Significant differences remain, creating systemic risk, competitiveness issues and regulatory-arbitrage opportunities
Sanctions	Ensure stress tests result in improved resilience	<ul style="list-style-type: none"> • Uncertain in the Eurozone due to limited ability of EU regulators to sanction banks
Corporate Governance	Ensure robust stress tests	<ul style="list-style-type: none"> • EU tests focus principally on numerical results with unclear link to improvements in bank capital-planning, governance capacity
Capital Focus	Ensure resilience under stress	<ul style="list-style-type: none"> • EU focus solely on capital adequacy may, as in U.S. stress tests, overlook emerging market, liquidity, operational risks

Capital Requirements for Swap Entities

As required by section 731 of the Dodd-Frank Act, the CFTC issued a proposal which mandates capital requirements for swap entities, including swap dealers and major swap participants. Under this proposal, swap entities under the jurisdiction of a prudential regulator (i.e., FRB, FDIC, OCC, FHFA, and the Farm Credit Administration) would be required to meet the capital requirements set by the applicable prudential regulator while all others would be subject to the CFTC’s capital rules. The CFTC proposal creates three categories of swap entities with different capital requirements. Futures Commission Merchants (FCMs) would be required to maintain adjusted net capital levels of at least \$20 million, although adjustments for foreign-exchange transactions and margin requirements, or registration with a futures association or the SEC may significantly raise mandated capital levels. Non-FCM swap entities that are nonbank subsidiaries of U.S. BHCs would generally be required to meet the same capital requirements as their BHC parents. Swap entities that are neither FCMs nor BHC subsidiaries would be required to hold at least \$20 million in tangible net equity, as well as additional amounts for market risk and OTC derivatives credit risk.

Issue	Intended Impact	Possible Unintended Impact
Haircuts on Derivatives for FCMs	Ensure that FCMs retain sufficient liquidity by adjusting capital levels for market and credit risk	<ul style="list-style-type: none"> • The haircuts for derivatives may be inappropriate as they are based on fixed income and equity cash positions • The lack of recognition for hedging and risk management used by swap entities reduces incentives to hedge and, thus, reduce risk
Risk-Based Capital Rule for FCMs	Require FCMs to maintain a minimum level of capital (i.e., 8 percent of the risk margin on cleared future and swap positions in customer and non-customer accounts) that reflects the level of risk associated with carried customer positions	<ul style="list-style-type: none"> • Undue capital since margin requirements also rise • This leads to higher capital requirements when actual counterparty credit risk is reduced through higher margin requirements

Issue	Intended Impact	Possible Unintended Impact
Capital Requirements for Non-FCM, BHC Subsidiaries	Consistent capital requirements for BHCs and their subsidiaries	<ul style="list-style-type: none"> • Lack of explicit coverage for subsidiaries of foreign financial holding companies could result in competitive inequality
Capital Requirements for Non-FCM, Non-BHC Subsidiaries	Adjust capital requirements for firms that are generally commercial end-users and not market intermediaries	<ul style="list-style-type: none"> • Minimum capital requirements for these firms may be too low • Calculation of tangible net equity incorporates less liquid assets which could result in swap entities with too little liquidity to support their swap positions
Standardized Capital Models	Limitations on CFTC resources prevent it from reviewing and approving the use of proprietary internal models which account for market and credit risk	<ul style="list-style-type: none"> • Standardized models set capital levels that do not accurately reflect risk exposures • They are less granular, insufficiently risk sensitive, difficult to update, and incompatible with risk management process
Internal Models Approved by Prudential Regulator/SEC	CFTC assurance that models approved by other regulators meet its needs	<ul style="list-style-type: none"> • Undue burden as these models are already approved by federal prudential regulators, after a rigorous review process, and may more accurately reflect risk exposures • Prudential regulators also examine these models and require frequent updating which may conflict with delayed CFTC approval and add risk
Internal Models Approved by Foreign Regulator	Limitations on CFTC resources prevent it from reviewing and approving the use of proprietary internal models which account for market and credit risk	<ul style="list-style-type: none"> • The models approved by prudential regulators address relevant factors for the affected foreign institution • Possible barrier to trade in financial services in this sector

Issue	Intended Impact	Possible Unintended Impact
Capital Charge for Swap Valuation Disputes	Additional capital reserves for swap entities when a counterparty is unwilling to provide sufficient collateral	<ul style="list-style-type: none"> • Possible duplicative capital requirements as swap entities already reserve capital for such disputes as unsecured credit exposures
Implementation Period	Gradual implementation to ensure that the rules do not disrupt the swap market	<ul style="list-style-type: none"> • 60-day implementation period may be insufficient and lead to market disruption

Risk Management

Volcker Rule: Proprietary Trading

The Dodd-Frank Act contains provisions generally known as the Volcker Rule designed to restrict the ability of banks, bank holding companies, and their affiliates (“banking entities”) from proprietary trading. This restriction is based on the view that proprietary trading is incompatible with the various taxpayer-supported safety nets available to banks. At the same time, the Volcker Rule permits banking entities to engage in certain proprietary trading activities, such as market making, hedging of individual or aggregated positions, underwriting, and trading in U.S. government obligations. The Volcker Rule also allows regulators to permit additional types of proprietary trading provided certain conditions are present. In the Fall of 2011, the U.S. regulators issued a lengthy and complex proposal to implement the Volcker Rule that raised at least as many questions as it proposed to answer. The regulators received thousands of comment letters in response to their proposal and have not yet issued a final rule. As a result, no final rule was in place at the statutory deadline, July 21, 2012, although banking entities have two years to conform their activities to the Volcker Rule. To clarify the compliance obligations of banking entities during this conformance period, in April 2012, the FRB issued guidance providing that banking entities should engage in good-faith planning efforts to enable them to conform their activities to the statute and the yet-to-be adopted final rule by July 21, 2014. There is no comparable restriction on proprietary trading in other jurisdictions, although the U.K. is advancing “ring-fencing” standards to separate commercial from investment banking.

Issue	Intended Impact	Possible Unintended Impact
Market Liquidity	Prevent undue risk	<ul style="list-style-type: none"> • Reduced liquidity, increased borrowing costs, reduced asset values • Implementation of market making exemption may result in an estimated: <ul style="list-style-type: none"> ○ \$90-315 billion in mark-to-market value losses for investors as lower liquidity erodes the value of assets ○ \$12-43 billion per year in costs to corporate issuers due to increased borrowing costs ○ \$1-4 billion in annual transaction costs for investors • Liquidity/cost implications likely to be most acute for smaller issuers and customers that rely principally on banks and their affiliates

Issue	Intended Impact	Possible Unintended Impact
Market-Making	Exempt market-making from banned proprietary trading	<ul style="list-style-type: none"> • Complexity of definitions effectively bars legitimate market-making • Problem most acute for smaller banks that make markets in less liquid assets that require longer holdings by bank underwriter
Hedging	Permit bona fide hedging to reduce risk related to permissible trading and other activities	<ul style="list-style-type: none"> • Barrier to effective hedging due to transaction-by-transaction assessment of intent, correlation, and risk, complex standards, possible limits on essential portfolio hedging to address macroeconomic and other risks
Regulatory Coordination	Consistent rules and implementation across all covered firms	<ul style="list-style-type: none"> • Divergent standards, examination policies and transaction-by-transaction review may lead to wide variance in standards/enforcement resulting in opportunities for regulatory arbitrage, competitiveness concerns
Earnings Impact	Reduce volatility, short-term incentives	<ul style="list-style-type: none"> • Reduce earnings-stream diversity, concentrating risk and making banks less able to commit to long-term loans, other obligations
Sovereign Obligations	Protect the U.S. government and agency bond market with a specific exemption and protect all other market making through the market making exemption	<ul style="list-style-type: none"> • Adverse liquidity consequences for other high-quality sovereign issuers, exacerbating EU crisis, creating barrier to global financial-regulatory framework and, perhaps, entry by U.S. firms to foreign markets

Issue	Intended Impact	Possible Unintended Impact
Municipal Obligations	Protect banking trading in municipal bonds	<ul style="list-style-type: none"> • Limitation of permissible municipal bonds only to general-obligation ones could create significant disruptions to revenue financing for state and local governments that are already finding it difficult to raise cost-effective funds for needed infrastructure • Cost increases of particular concern to smaller issuers without ready access to capital markets which depend on regional banks
Commodity Activities	Permit banking entities to continue to engage in commodity spot and forward transactions	<ul style="list-style-type: none"> • NPR unclear with regard to these activities • If covered, transactions related to energy, other needed commodities denied bank servicing, raising cost, limiting availability
Cost/Benefit Analysis	Ensure a well-balanced regulation	<ul style="list-style-type: none"> • Lack of transparent, analytical criteria may lead to unduly burdensome rule, perverse results
Compliance Standards	Ensure full compliance	<ul style="list-style-type: none"> • Complexity of proposal makes compliance judgment often subjective, burdensome for all banks (especially smaller ones) • Compliance burden and legal/reputational risk may lead banking entities simply to exit activities that provide market and customer liquidity, other benefits

Volcker Rule: Covered Funds

The Volcker Rule not only restricts certain types of proprietary trading, but also prohibits banking entities (i.e., banks, bank holding companies and their affiliates) from “sponsoring” or acquiring or retaining any “ownership interest” in a “hedge fund” or “private equity fund” except under a permitted activity exemption. The Volcker Rule also prohibits a banking entity from engaging in certain “covered transactions” with a sponsored or advised hedge fund or private equity fund, including extending credit to or acquiring the assets of or securities issued by such a fund, or engaging in derivative or securities borrowing or lending transactions with such a fund resulting in credit exposure to the fund. This was included in the law on grounds that these investments could permit evasion of the proprietary trading restrictions, are unduly risky, and create conflicts of interest. The Volcker Rule becomes effective on July 21, 2012. However, because the five agencies charged with implementing the law have yet to finalize implementing rules, the FRB has indicated that banks will have the full two year conformance period, ending July 21, 2014, in which to bring their activities, investments and relationships into conformance with the Volcker Rule. No other country has to date adopted any comparable restriction on investments in private funds by banking organizations.

Issue	Intended Impact	Possible Unintended Impact
Definition of “Covered Fund”	Block risky investments	<ul style="list-style-type: none"> • Overbroad definition fails to carve out ordinary corporate structures that have never been considered hedge funds or private equity funds, such as wholly owned subsidiaries, joint ventures and acquisition vehicles • Designation of “commodity pools” as “similar funds” also potentially captures many entities inappropriately • Designation of foreign funds as “similar funds” could capture many retail and other types of vehicles inappropriately

Issue	Intended Impact	Possible Unintended Impact
Definition of “Banking Entity”	Defines entities within banking organization subject to Volcker Rule	<ul style="list-style-type: none"> As drafted, results in many unintended consequences, such as applying the Volcker Rule restrictions to hedge funds themselves, registered mutual funds, portfolio companies
Definition of “Sponsor” – Trustee	Defines class of activity subject to Volcker Rule	<ul style="list-style-type: none"> Could be read to capture types of trustees with no investment discretion but mere discretion over collateral or cash management activities
“De Minimis” Investments as Part of Asset Management Exemption	Permit banking entities to co-invest a small amount, as demanded by the market	<ul style="list-style-type: none"> Attribution rules as drafted could adversely affect or effectively eliminate banking entities’ ability to employ traditional fund of funds and master-feeder structures
Underwriting and Market Making Exemption	Permit traditional underwriting and market making function of banking entities	<ul style="list-style-type: none"> May fail to incorporate the statutory exemption for underwriting and market making in hedge funds and private equity funds
Securitization	Securitization exclusion was intended to limit negative impact of prohibitions on securitizations	<ul style="list-style-type: none"> Overly broad definition of covered funds/overly narrow securitization exclusion includes many common securitization transactions Lack of corresponding exclusions from inter-affiliate transaction standards renders securitization exclusion from covered fund definition useless

Issue	Intended Impact	Possible Unintended Impact
Risk-Mitigating Hedging	Permit banking entities to appropriately manage risk	<ul style="list-style-type: none"> • Hedging exemption for covered funds may unnecessarily single out covered fund-linked products
Inter-Affiliate Transaction Limits	Limit risk through loans, etc. to covered funds	<ul style="list-style-type: none"> • May prohibit clearing and settlement and other traditional, low-risk inter-affiliate activities • May threaten ability of banking entities to manage risk within their organizations
Public-Welfare Funds	Exempt to protect policy goals	<ul style="list-style-type: none"> • Limited exemption in practice includes many activities related to public-welfare funds, reducing bank role and capital available for community development
Compliance	Ensure effective compliance with investment prohibitions	<ul style="list-style-type: none"> • Complexity, differences among implementing agencies creates uncertainty that could lead banks to shed otherwise-permissible investments, exacerbating cost, market disruption, competitiveness concerns
Cost/Benefit Analysis	Ensure appropriately balanced rule	<ul style="list-style-type: none"> • Lack of quantitative or transparent cost/benefit analysis makes burden, adverse-impact assessment impossible for regulators, markets

Conflict-of-Interest Regulation

Conflicts of interest are a longstanding risk-management and prudential concern, but became particularly worrisome in the run-up to the financial crisis. In its wake, numerous enforcement actions have concluded that some institutions were conflicted because they structured asset-backed securities (ABS) with possible risk and withheld telling clients while at the same time taking positions to profit from losses on these same ABS. Based on this, the Dodd-Frank Act includes provisions requiring specific conflict-of-interest standards based on possible problematic securitization practices. The SEC has proposed a rule to implement these Dodd-Frank requirements, but has not yet finalized it.

Issue	Intended Impact	Possible Unintended Impact
Economic Impact	Ensure conflicts of interest are barred without damaging economic growth	<ul style="list-style-type: none"> • Uncertain impact since NPR has only an inconclusive economic-impact statement while noting that the rule could create a strong disincentive for ABS adverse to prudent credit availability
Defining Conflicts of Interest	Robust barriers to problematic ABS structures	<ul style="list-style-type: none"> • Lack of clear standards that go to intent to disadvantage clients may undermine securitization/hedging
Risk Management	Bar conflicts without undermining effective risk management	<ul style="list-style-type: none"> • Broad definitions, other problems may bar needed hedges related to ABS
Disclosure	Ensure market knowledge of possible conflicts	<ul style="list-style-type: none"> • Lack of recognition of disclosure related to conflict of interest may unduly curtail ABS issuance, undermine market efficiency

Issue	Intended Impact	Possible Unintended Impact
Coverage of Firms	Bar conflicts of interest	<ul style="list-style-type: none"> • Broad coverage creates legal risk since complex, cross-border firms have many affiliates (e.g., banks, investment managers) who are barred by law or otherwise blocked from knowing of ABS operations elsewhere in the firm • Failure to reflect firewalls that block information and thus may create seeming conflicts could create significant legal risk, reduce ABS volumes, curtail global access to desired investments
Covered ABS	Cover all structures with potential conflicts of interest	<ul style="list-style-type: none"> • Broad definition goes beyond traditional understanding of ABS to cover certain municipal securities, corporate-debt restructurings, internal risk-management transactions • This results in restrictions on risk management, other activities that pose no meaningful conflicts of interest and could reduce liquidity/credit-availability in affected sectors
GSE and USG MBS	NPR would appear to cover these mortgage-backed securities like other ABS	<ul style="list-style-type: none"> • GSE and USG MBS are unique in terms of amount, role in global financial markets (e.g., dependence of U.S. mortgage finance on them and need to ensure a to-be-announced or TBA market for mortgages) • TBA structures create seeming conflicts that the market disregards but might still be barred by this rule and, if so, secondary U.S. mortgage markets would be severely disrupted • Lack of credit risk for these MBS (due to USG guarantee) prevents conflicts feared by Dodd-Frank • Coverage could also prevent risk-sharing sought by GSE regulators to reduce taxpayer exposure to Fannie Mae and Freddie Mac

Ring-Fencing

Global regulators have identified institutional complexity as a factor that exacerbates systemic risk, especially when financial-services firms operate in branched networks across national borders that create uncertainty surrounding legal domicile and home/host regulatory authority or resolution regime. National regulators (e.g., in the U.K.) are using “ring-fencing” – that is, segregating individual business lines within a banking organization – in hopes of protecting depository activities from non-deposit investment-banking activities. The European Union is considering the need for similar segregation. U.S. law mandates certain barriers between the activities of the depository institution (e.g., limits on the authority of a national bank to conduct insurance/securities underwriting), although boundaries can be porous absent express federal/state regulatory criteria. However, the U.S. also has restrictions, tightened in Dodd-Frank, on the extent to which depositories can fund non-bank affiliates. Ring-fencing means that activities within a bank or BHC are separated by robust barriers such as these inter-affiliate transaction limits.

Issue	Intended Impact	Possible Unintended Impact
Activity Barriers	Prevent contagion risk within a complex banking organization	<ul style="list-style-type: none"> • Definition of activities (e.g., what is “proprietary trading”) can be complex and do unintended harm to activities needed for safe and sound banking, effective customer/market services
Complexity	Reduce integration of activities, risks within a single financial firm to facilitate management, regulation, resolution	<ul style="list-style-type: none"> • Artificial barriers, information firewalls inhibit effective enterprise-wide risk management
Local Operational Capacity	Require infrastructure to ensure robust local operations	<ul style="list-style-type: none"> • Limits expertise and resilience for bank operations because efficiencies of cross-unit services curtailed or eliminated

Issue	Intended Impact	Possible Unintended Impact
Orderly Resolution	Ring-fence complex banks to ensure orderly resolution	<ul style="list-style-type: none"> • Express statutory limits may be less effective than ongoing living wills designed to ensure orderly resolution without taxpayer support under varying market/economic conditions
Liquidity	Ensure ample liquid assets to absorb specific risk	<ul style="list-style-type: none"> • Individual market/line-of-business liquidity strains exacerbated by lack of parent resources • May force greater use of central-bank liquidity/swap facilities, increasing taxpayer risk

Subsidiarization

“Subsidiarization” goes beyond ring-fencing to require separate incorporation of activities, often conducted through branches, with all of the additional legal, governance and related standards that apply to separate corporate entities. Subsidiarization does not necessarily dictate activity restrictions or even barriers, but rather imposes separate legal structures designed to make it easier to track exposures, ensure governance and assign clear jurisdictional responsibility. The concept is under consideration in the U.S. by the FDIC, which has considered imposing restrictions on offshore branches of U.S. insured depositories. Subsidiarization is also a major focus of living wills, as regulators look to corporate structures to determine intra-group linkages and exposures.

Issue	Intended Impact	Possible Unintended Impact
Prudential Implications	Separate entities to prevent intra-group contagion, conflicts of interest	<ul style="list-style-type: none"> • Artificial barriers to intra-group and cross-border transfers of capital, liquidity, or operational capability may create safety-and-soundness risk and undermine efficient operations
Capital Costs	Ensure specific regulatory capital for identified risk	<ul style="list-style-type: none"> • Capital for subsidiarized entities likely 1.5 to 3 times higher than for integrated operations, thereby increasing cost of operations, reducing credit availability, and undermining competitiveness
U.S. Impact	Protect U.S. market, FDIC, FRB	<ul style="list-style-type: none"> • Isolates U.S. from foreign financial resources, increases risk for foreign financial entities doing business in U.S • Creates protectionist barriers to entry, undermining global financial framework

Issue	Intended Impact	Possible Unintended Impact
Subsidiarization by National Domicile	Ensures clear legal identification, regulatory jurisdiction	<ul style="list-style-type: none"> • Legal entity identifier (LEI) now required by the G-20 intended to track parent-company responsibility, facilitating jurisdiction/regulatory identification in branched firms and avoiding need for costly subsidiarization
Orderly Resolution	Subsidiarize complex banks to ensure orderly resolution	<ul style="list-style-type: none"> • Express statutory limits may be less effective than ongoing living wills designed to ensure orderly resolution without taxpayer support under varying market/economic conditions
FDIC Premiums	Charge higher large-bank premiums based on risk of offshore branches to force subsidiarization	<ul style="list-style-type: none"> • Penalizes banks for diverse funding sources
Lending Limits	Prevent concentration risk	<ul style="list-style-type: none"> • Artificial limits bar banks from servicing large customers across borders, undermining competitiveness, trade finance
Legal Authority of Host Jurisdiction	Ensure clear domicile through subsidiarization	<ul style="list-style-type: none"> • Requires application of inappropriate rules to host-country customers, operations • Complicates supervisory/litigation enforcement
Netting/Hedging	Ensure clear assignment of risk mitigation to specific transactions	<ul style="list-style-type: none"> • Complicates aggregated risk mitigation of cross-jurisdiction/entity/activity risk

Issue	Intended Impact	Possible Unintended Impact
Liquidity	Ensure ample liquid assets to absorb specific risk	<ul style="list-style-type: none"> • Individual market/line-of-business liquidity strains exacerbated by lack of parent resources • May force greater use of central-bank liquidity/swap facilities, increasing taxpayer risk
Corporate Governance	Ensure subsidiary-level accountability	<ul style="list-style-type: none"> • Lack of expertise to ensure appropriate risk management for complex activities, intra-group risk • Increased complexity of internal audit/risk management complicates accountability, expertise
Cross-Border Data Flow	Permit ongoing flow of vital data	<ul style="list-style-type: none"> • Subsidiarization may bar cross-border data due to host-country restrictions, separate legal requirements that undermine consolidated risk management by the parent, supervision of group as a whole
Rule of Law	Ensure applicable for all financial-institution operations	<ul style="list-style-type: none"> • Subsidiarization may increase legal risk if activities housed in jurisdictions without clear rule of law • Need to ensure clear rule of law for operations discourages entry to emerging markets, improvement in host-country financial system, access to development finance
Taxation	Ensure all activities subject to appropriate taxation	<ul style="list-style-type: none"> • Subsidiarization sharply increases parent tax liability, undermining efficient operation and encouraging exit from high-tax jurisdictions
D-SIB Surcharge	Impose added capital when bank operations pose systemic risk in a national jurisdiction	<ul style="list-style-type: none"> • Surcharge based on subsidiaries could lead banks to avoid certain markets if barred from branching with adverse credit-availability, economic-efficiency impact in affected nations

U.S. Credit-Exposure Limits

Large, concentrated exposures are a longstanding prudential concern, as concentrated credit, liquidity and related risks can undermine a financial institution’s resilience. As a result, a series of efforts are under way to ensure that exposures to single counterparties are limited to levels banks can absorb under stress. Efforts in this area include a provision in the Federal Reserve’s proposed systemic regulation to impose a single-counterparty credit limit (SCCL), an outstanding FRB/FDIC proposal related to reporting of credit exposures, and a recent proposal from the OCC to expand loan-to-one-borrower limits to broader asset classes. The FDIC also charges large banks higher deposit-insurance premiums if they have large SCCLs.

Issue	Intended Impact	Possible Unintended Impact
FRB Restrictions	Limit credit exposures not just to 25% of capital per SCCL (as Dodd-Frank requires), but also to 10% of capital for very large bank exposures to large counterparties	<ul style="list-style-type: none"> • FRB approach reaches \$1.3 trillion in current credit exposures and could require reduction in derivatives by \$3—75 trillion in notional value, forcing significant market disruption, potential limits on credit availability or even macroeconomic cost
Controlling Concentrated Risk	Improve institution, market resilience; limit contagion in the event of financial crisis	<ul style="list-style-type: none"> • Focus to date only on credit exposures distracts from risk concentrations in other areas (e.g., liquidity, operational) that also pose single-institution/market risk • The array of pending U.S./global SCCL standards results in different measures for different institutions under varying circumstances for SCCLs, creating burden, competitiveness concerns and confused enforcement

Issue	Intended Impact	Possible Unintended Impact
Credit Risk	Measure SCCL stringently to prevent risky concentrations	<ul style="list-style-type: none"> • FRB proposal limits hedging recognition, creating unrealistic views of risk and a perverse incentive against risk mitigation • Risk is so “grossed up” that credit availability could be significantly adversely affected and result in reduced GDP growth/employment • Different exposure definitions in FRB rule regarding systemic risk and FRB/FDIC NPR regarding resolution complicates measurement of risk and promotes additional gross-up without real regard to differentiated risk based on the nature of an exposure (e.g., credit vs. equity, funding vs. unfunded, etc.)
Extent of SCCL	By going beyond the Dodd-Frank 25% SCCL also to propose a 10% limit for exposures to certain large institutions, the FRB hopes to break up inter-connectedness	<ul style="list-style-type: none"> • More restrictive limits increase risk of unintended macro and institutional consequences, especially given limits on ability to recognize hedging
Transparency	Promote clear risk limits	<ul style="list-style-type: none"> • FRB NPR does not explain method used to arrive at key provisions, decision to go beyond Dodd-Frank; Thus, premises may not be supported by research, cost/benefit analyses • Rule effectively imposes even stricter limitations since banks would need to have cushion below limits to ensure compliance
Definition of Counterparty	Cast broad net to cover all potential risk exposures	<ul style="list-style-type: none"> • Captures CCPs and thus undermines Dodd-Frank goal of promoting use of central clearing to enhance OTC market transparency, stability • Coverage of affiliates, joint ventures in FRB NPR increases “gross-up” problems, including with regard to credit availability • Consolidation of exposures between certain banks and home countries creates artificial gross-up of risk

Issue	Intended Impact	Possible Unintended Impact
Capital Charge	Capture risk of SCCLs and create disincentive for bank exposures to shadow firms	<ul style="list-style-type: none"> • Punitive, redundant in light of other SCCL requirements in U.S.
Coverage of Sovereign Exposures	Limit risky sovereign credit exposures	<ul style="list-style-type: none"> • Treats non-U.S. sovereigns as unduly risky
Treatment of Credit-Risk Protection	Cover all possible risk	<ul style="list-style-type: none"> • Creates disincentive for banks to get protection
Impact Analysis	Craft effective rule	<ul style="list-style-type: none"> • Uncertain since FRB has not presented quantitative-impact surveys, other data to substantiate proposed approach

International Credit-Exposure Limits

The U.S. SCCL rules come in concert with global developments. These include current SCCLs in the European Union and work under way in the Basel Committee to craft international credit-exposure standards. However, there are major differences between the U.S. proposals and EU rules, differences the Basel Committee may find difficult to harmonize in consistent international single-counterparty credit limits.

Issue	Intended Impact	Possible Unintended Impact
Counterparty Constraints	Govern risky positions	<ul style="list-style-type: none"> • EU standards restrict counterparty exposures above 25% of capital, in contrast to FRB coverage not only at this level, but also at 10% of capital for larger exposures • Differences could make FRB standards cause for competitiveness problems, disruption in global market as large financial institutions would rely principally on EU banks, increasing their concentration risk and creating regulatory-arbitrage opportunities
Over-Limit Exposures	EU permits as long as higher capital held	<ul style="list-style-type: none"> • Flexible approach in contrast to FRB flat ban
Sovereign Coverage	EU exempts all high-quality sovereigns and CCPs	<ul style="list-style-type: none"> • Coverage of sovereigns, CCPs in FRB proposal poses sovereign-liquidity/diplomatic concerns, increasing risk of transfer of exposures outside U.S.
Risk Shifting	EU does not attempt to shift risks to third parties and compile for SCCL calculation	<ul style="list-style-type: none"> • U.S. combination of direct and indirect exposures creates disincentive to risk mitigation

Issue	Intended Impact	Possible Unintended Impact
Risk Measurement	EU permits use of Basel II methodologies	<ul style="list-style-type: none"><li data-bbox="890 272 1829 337">• Different methodology in FRB proposal could increase divergence in global financial regulation

Inter-Affiliate Transactions

U.S. law has long imposed limits (found in Sections 23A and 23B of the Federal Reserve Act and the FRB’s Regulation W) on transactions between insured depositories and their affiliates (as well as between U.S. branches of foreign banks and certain of their affiliates). These rules impose quantitative and qualitative limits on inter-affiliate transactions to limit a bank’s risk of loss in transactions with affiliates and to limit a bank’s ability to transfer to its affiliates the benefits arising from its access to the Federal safety net. Section 608 of the Dodd-Frank Act, which was effective on July 21, 2012, significantly tightened and extended these inter-affiliate transaction restrictions. To date, these inter-affiliate restrictions are principally a U.S. standard, with the “universal” bank model adopted elsewhere largely permitting unfettered intra-group transactions. However, pending reforms in the United Kingdom would “ring-fence” traditional banking from investment-banking affiliates, imposing significant inter-affiliate restrictions. U.K. living will requirements, like those of the U.S., also address this issue, as will global standards if they are finalized in accordance with recent statements from the Financial Stability Board.

Issue	Intended Impact	Possible Unintended Impact
Transaction-Restriction Impact	Reduce intra-group risk, any unfair advantages for BHCs	<ul style="list-style-type: none"> • Undermines efficient BHC operation, with possible risk from use of insured deposits addressed through new FRB powers to regulate all aspects of a bank/financial holding company
Credit Exposures on Derivatives and Securities Financing Transactions	Restrict credit exposure on derivatives and securities financing transactions; permit FRB to define “credit exposure”	<ul style="list-style-type: none"> • “Credit exposure” is not defined in the statute, thus complicating implementation in the absence of guidance from the FRB • Unclear integration with definition of credit exposure for purposes of the single-counterparty credit limit, incomplete FRB rule re credit exposures for resolution plans. Inconsistent standards will confuse compliance, create market uncertainties and undermine effective supervision

Issue	Intended Impact	Possible Unintended Impact
Treatment of Investment Funds	Reduce risk to banks posed by transactions with investment funds for which the bank or an affiliate thereof is the investment adviser	<ul style="list-style-type: none"> • Limits ability of banks to protect investors
Treatment of Complex Exposures	Restrict banks' exposure to securities-financing, repurchase, derivatives risk	<ul style="list-style-type: none"> • Complicates effective risk management • Creates incentive to house permissible complex transactions in insured depositories, actually increasing potential risk
Interconnectedness	Limit bank intra-group risk, reducing exposures to non-traditional, non-banking activities	<ul style="list-style-type: none"> • Duplicative of G-SIB surcharge designed to tax large U.S. banks for systemic risk in part resulting from inter-connectedness, with FRB systemic rules (especially re credit exposures) designed to curb risks • Duplicative of living wills require ability of insured depositories to absorb affiliate-related risk (specific FDIC rules imposed here) • Intra-group restrictions thus redundant with developing systemic-risk framework and unduly burdensome
Collateral	Ensure affiliate transactions are collateralized over entire term, not just at outset	<ul style="list-style-type: none"> • May reduce holding-company resources, liquidity under stress, especially if insured depository otherwise sound and does not need collateral

Issue	Intended Impact	Possible Unintended Impact
Netting	Permit prudent recognition of netting to measure inter-affiliate transactions	<ul style="list-style-type: none"> • Because the FRB has not provided guidance regarding netting, it is unclear how netting agreements may be taken into account for purposes of determining credit exposure • Uncertain rules, case-by-case action could lead to inconsistent standards • Failure to fully recognize effective hedges would exacerbate operational impact of inter-affiliate transaction limits
Exemptions	Permit regulators to exempt inter-affiliate transactions to promote efficiency, avoid unintended consequences, but give FDIC more power to prevent risk	<ul style="list-style-type: none"> • Complex regulatory approval process for obtaining an exemption likely to result in longer processing time or limit the availability of exemptions

Swap Push-Out Rule (“Lincoln Amendment”)

The Lincoln Amendment, section 716 of the Dodd-Frank Act, effectively bans a financial institution with access to federal assistance – e.g., FRB credit facilities and the discount window and FDIC guarantees and deposit insurance – from acting as a swaps dealer except in limited circumstances. However, insured depository institutions (IDIs) are exempted if their swaps activity is limited to hedging or they serve as a swaps dealer for cleared CDS and swaps involving rates or reference assets that are permissible investments for national banks. In addition, IDIs that are part of an FRB-supervised holding company are not prohibited from having a swaps-entity affiliate so long as it meets FRB, SEC and CFTC requirements.

Issue	Intended Impact	Possible Unintended Impact
Macroeconomic Impact	Gradual implementation during a two-year transition period beginning July 16, 2013, with a potential one-year extension, to ensure that the rule does not undermine economic recovery	<ul style="list-style-type: none"> ● Transition period offered to financial institutions is undercut by FSOC’s discretionary authority to immediately ban access to federal assistance on an institution-by-institution basis
Reduce Systemic Risk	Eliminate swaps-related activities by banks which raise systemic risk concerns that could result in taxpayer bailouts	<ul style="list-style-type: none"> ● Pushing swaps activities into affiliates will reduce bank revenues without improving systemic risk regulation as these affiliates are subject to less comprehensive regulation
Safe Harbor for Affiliates	Insulate IDIs from swaps related risk and limit nonbank affiliate access to federal assistance	<ul style="list-style-type: none"> ● Raises customer costs for swap transactions ● Increases bank funding requirements to capitalize an affiliate ● Strong incentive for customers to turn to foreign banks to meet their derivatives needs

Issue	Intended Impact	Possible Unintended Impact
Foreign Banks with U.S. Branches	Unknown intent, possibly an oversight during Dodd-Frank's enactment	<ul style="list-style-type: none"> <li data-bbox="1073 272 1871 370">• Uninsured U.S. branches of foreign banks may not benefit from exemptions, grandfathering and conformance period provisions that on their face apply only to insured depositories

Section 165 Risk Management Requirements

The financial crisis revealed significant deficiencies in risk management practices at large, complex financial institutions, which the proposed Section 165 risk management rules of the Dodd-Frank Act are intended to address. The rules, which are aimed at establishing risk management standards as part of the regulatory and supervisory framework, require BHCs and banks with more than \$10 billion in total assets to establish an enterprise-wide risk committee of the board of directors charged with specific risk management responsibilities. Covered companies (BHCs with assets over \$50 billion and systemic nonbanks) are also subject to heightened standards, including requirements for the independence of the firm’s risk management function and for the qualifications and duties of the chief risk officer (CRO).

Issue	Intended Impact	Possible Unintended Impact
Governance Standards	Strengthen board oversight of risk management policies and procedures	<ul style="list-style-type: none"> • Blurs the distinction between the proper oversight role of the Board of Directors and management’s responsibility for day-to-day operations • Boards and committees may be overwhelmed, impairing ability to provide independent and objective strategic direction, senior-management oversight
Board Expertise	Ensure that directors have requisite experience and knowledge to govern complex transactions, anticipate emerging risk	<ul style="list-style-type: none"> • Expertise standards are set so high that they may significantly narrow the pool of eligible directors with diverse backgrounds needed for appropriate governance of factors such as community service, operational/reputational risks
Interaction with Other Committees	Establish one committee with sole responsibility for risk management	<ul style="list-style-type: none"> • Creates a “silo” that isolates critical risk-management consideration from other board committees (e.g., audit, credit, finance) • Increases burden on risk-management committee that may undermine effectiveness

Issue	Intended Impact	Possible Unintended Impact
CRO Reporting Line	Dual reporting by the CRO to the risk committee and chief executive officer to ensure effective implementation of risk management standards	<ul style="list-style-type: none"> • A single corporate governance model may not be appropriate for all organizations • Could impair effective risk management by complicating the relationship between management and board • Specific requirements may limit pool of qualified candidates, preventing development of skilled CRO corps with diverse expertise
Harmonization with Other Risk Standards	Create tougher standards for larger, more complex and/or systemic firms	<ul style="list-style-type: none"> • Other regulators mandate risk-management standards, leading to possible conflict, confusion, lack of supervisory accountability • Lack of materiality standard for systemic risk-management compliance that triggers early remediation exacerbates complexity of rules • Potential for unnecessary sanctions
Application to Nonbank Financial Companies	Ensure appropriate risk management and governance	<ul style="list-style-type: none"> • Bank-centric approach could have the perverse result of reducing the effectiveness of nonbank risk management by requiring board/CRO focus on less-relevant risk indicators • Creates undue burden because FRB requirements depart from those mandated by nonbank supervisors

Section 166 Early-Remediation Standards

Section 166 of the Dodd-Frank Act mandates new “early-remediation” standards for BHCs with assets over \$50 billion and any nonbank financial company declared systemic. The FRB has proposed stringent new requirements here, which build on those dictating prompt corrective action for all insured depositories. PCA has been in place since 1991, but the pending U.S. proposals to implement the Basel III risk-based capital rules redefine and toughen PCA. Early remediation creates an additional layer of triggers dictating supervisory action at the parent-company level, although the degree to which these relate to PCA for subsidiary insured depositories (often the preponderance of a BHC’s assets) will not be clear until the FRB reconciles all of these proposals (which it says it plans to do). In general, the proposed early-remediation requirements are still tougher than the proposed PCA requirements. Additionally, early remediation could be triggered by market indicators and supervisory factors beyond capitalization, including failure under systemic risk-management, liquidity, and stress-test standards separately proposed by the FRB.

Issue	Intended Impact	Possible Unintended Impact
Systemic Standards	Uniform early remediation for all systemic firms to prevent failure	<ul style="list-style-type: none"> • FRB proposals base triggers on bank rules not applicable to nonbanks, creating a system that could effectively shutter some nonbanks even though they are not risky • Conflict with early-remediation requirements already applicable to some nonbanks (e.g., insurers)
Government Takeover	Prevent systemic risk due to FRB recommendation that troubled firms be put into orderly liquidation due to failure to meet critical early-remediation standard	<ul style="list-style-type: none"> • Resolution through this process may not include opportunity for firm to protest/correct (otherwise provided), creating risk of closing viable firms, increasing temporary cost to taxpayers and long-term cost to other systemic firms

Issue	Intended Impact	Possible Unintended Impact
Use of Stress Tests to Trigger Early Remediation	Ensure early remediation	<ul style="list-style-type: none"> • Uncertain relation between systemic stress tests (including company-run ones) with FRB-dictated stress tests, leading to conflicting results that could confuse regulators and delay needed early remediation or lead to premature intervention sanctioning sound firms
Initial Early-Remediation Trigger	Ensure SIFIs always well capitalized	<ul style="list-style-type: none"> • Imposes stringent and mandatory remediation requirements such that, when firms slip below the new, very high thresholds proposed for U.S. banks, competitiveness, credit-availability, other unnecessary problems result
Sanctions	Promote prudent operation through sanctions beyond recapitalization orders (e.g., through business-activity, compensation, inter-affiliate restrictions)	<ul style="list-style-type: none"> • Non-public nature of initial sanctions could lead to undue intervention without transparency that promotes regulatory accountability, fair application
Regulatory Coordination	Give FRB sole authority over SIFIs	<ul style="list-style-type: none"> • Lack of clear consultation with primary regulator could lead FRB to act unnecessarily, arbitrarily
Market-Indicator Triggers	Ensure FRB attuned to market risk identifiers that warrant intervention	<ul style="list-style-type: none"> • Minimal research on meaningful market indicators • Initial standards based on equity indicators that could evidence broader market factors not germane to intervention at specific firm (e.g. trading volatility)

Issue	Intended Impact	Possible Unintended Impact
Recovery Upon Notice	Private FRB notice to promote rapid recovery at affected SIFIs	<ul style="list-style-type: none"> • Could trigger securities-law public notice requirements • May subject SIFIs to premature market sanction and possible spark to broader systemic risk (e.g., liquidity runs); could cause a spiral at the firm rather than recovery
Risk Management	Ensure early remediation if risk-management, governance concerns	<ul style="list-style-type: none"> • Standards for intervention not based on material violations • Systemic risk-management so stringent that sanctions based on minor violation could lead to unnecessary, incorrect FRB action

Shadow/Nonbank Regulation

“Shadow” Bank Regulation

As global regulators craft an array of capital, prudential and resolution standards for banking organizations, they have become increasingly concerned that “shadow” firms – that is, unregulated or loosely regulated entities – can conduct comparable activities as banks without comparable regulation, creating new risks to consumers, investors and global market/economic stability. To address this, Dodd-Frank posits new systemic regulations for nonbank financial companies and the Financial Stability Board has promised heads of state in the G-20 that it will progress quickly through its shadow-bank work plan to specific action steps to block reliance on “shadow” products – principally seen as money market funds (MMFs) and securitization – and/or on shadow entities.

Issue	Intended Impact	Possible Unintended Impact
Global Framework	Global standards to limit shadow banking	<ul style="list-style-type: none"> • Differing implementation, lack of transparency creates “haven” regulatory regimes for shadow firms, regulatory-arbitrage opportunities • FSB peer-review process to address inconsistencies remains under development, lacks enforcement power
Shadow Action Plan	Deliberate action through agreed-upon issues towards final regulation	<ul style="list-style-type: none"> • Lengthy process means continued transfer of activities to shadow sector as bank regulation becomes ever more stringent
Nonbank Systemic Designation	Increase regulation and limit power of “shadow” banks	<ul style="list-style-type: none"> • Adds unnecessary bank-centric regulatory burden for otherwise-regulated firms (e.g., insurers, broker-dealers, asset managers) • Criteria for SIFI designation qualitative in U.S., uncertain/opaque elsewhere

Issue	Intended Impact	Possible Unintended Impact
Regulation of Shadow Firms Through Banks	Impose new standards/transaction restrictions on banks to limit funding for shadows, systemic inter-connectedness	<ul style="list-style-type: none"> • Unnecessary additional burden on banks premised on unproven assertion that funding cannot be obtained from other sources • Inter-connectedness best addressed through continued role of regulated banks as intermediaries, processors, etc. • Loss of market transparency to bank regulators if bank role curtailed
Scope of Shadow Banking	Capture through new rules for all forms of credit intermediation and/or maturity transformation	<ul style="list-style-type: none"> • Definition of these processes are bank-centric and thus do not address full range of shadow activities
Consumer Protection	Regulate payment-services, other providers to prevent “loopholes,” risk to vulnerable consumers	<ul style="list-style-type: none"> • Limiting new technologies/services could undermine innovation, availability to “unbanked”
MMF Regulation	Prevent spread of under-regulated products akin to bank deposits; reduce systemic risk	<ul style="list-style-type: none"> • Application of bank-centric regulatory model reduces MMF benefits to investors, market liquidity • Burdensome for MMFs in light of liquidity, other rules imposed since crisis
Securitization	Strengthen national efforts to impose risk retention requirements, standardization and transparency	<ul style="list-style-type: none"> • Widen, rather than narrower differences in national regimes • Decreases efficiency in global markets • Opportunities for regulatory arbitrage

Issue	Intended Impact	Possible Unintended Impact
ABCP Conduits	Regulate asset-backed commercial paper to prevent systemic risk	<ul style="list-style-type: none"> • Conduits already under bank regulation
Reliance on Sanctions	Ensure barriers to systemic risk	<ul style="list-style-type: none"> • Reliance on express prohibitions, capital charges, etc. adds complexity • Use of reports, disclosures could ensure transparency, supervisory accountability without perverse results

Nonbank Systemic Regulation

Although many pending rules aimed at preventing systemic risk are focused on banking organizations, global policy and U.S. law in fact cast a broader net to cover all systemically-important financial institutions (SIFIs), going on to also delineate SIFIs and G-SIFIs. With the exception of provisions in Dodd-Frank focused on nonbank financial companies that may pose systemic risk, the national SIFI regime and global standards remain largely incomplete. Similarly, global work to identify G-SIFIs other than G-SIBs is just beginning. The International Association of Insurance Supervisors (IAIS) has proposed a methodology to identify global systemically-important insurers (G-SIIs), with the International Organization of Securities Commissions (IOSCO) recently charged by the G-20 with doing the same in the securities/investment-management arena.

Issue	Intended Impact	Possible Unintended Impact
Global Framework	Comparable G-SIFI standards to prevent risk, limit regulatory arbitrage	<ul style="list-style-type: none"> • Varying standards, implementation pace may lead to wide disparity in global practice • May promote flight from G-SIBs to firms without access to central-bank liquidity, clear capital standards or other systemic-risk controls
G-SIFI Surcharge	Penalize G-SIFIs for being too big to fail	<ul style="list-style-type: none"> • Conflicts with FSB, other efforts to bar taxpayer support • Promotes expectation of intervention and moral hazard
G-SIFI Standards	Establish prudential requirements suitable for nonbanks	<ul style="list-style-type: none"> • Bank-centric approach to date limits systemic-risk mitigation, adds unnecessary burden
Relation to U.S. Standards	Harmonized framework	<ul style="list-style-type: none"> • U.S. rules permit wide scope of designated firms • FRB bank-like regulation different than G-SIFI principles discussed to date by global agencies

U.S. SIFI Designation

The Dodd-Frank Act gives the FSOC authority to designate nonbank financial companies as SIFIs for purposes of top-tier regulation by the Federal Reserve and coverage under the array of systemic capital, liquidity, resolution and related standards mandated by the Act. The FSOC has now finalized the designation criteria it will use to name nonbank SIFIs, and resolution of these firms (and perhaps other nonbanks) may be handled under the new orderly-liquidation authority (OLA) also created in Dodd-Frank to prevent taxpayer support if failure threatens U.S. financial-market stability. These U.S. nonbank SIFI standards are considerably more developed than comparable global efforts with regard to firm designation, regulation and resolution.

Issue	Intended Impact	Possible Unintended Impact
Designation Process	Ensure appropriate regulation to prevent systemic risk	<ul style="list-style-type: none"> • Lack of consideration of alternatives, clear consultation with primary regulators to enhance SIFI regulation without designation (exposes firms to strategic restructuring, cost due to FRB regulation in bank-centric fashion)
Designation Criteria	Capture SIFI risk for appropriate regulation	<ul style="list-style-type: none"> • Lack of conclusive research/definitive criteria for SIFI designation • Complexity of SIFI factors across full range of nonbank activities undermines objective cross-sectoral designation • Not tailored to consider characteristics or structures of different types of non-banks
International Impact	Protect U.S. from systemic risk related to foreign-firm operations	<ul style="list-style-type: none"> • Potential for poor coordination, lack of complete information from home-country regulators may lead to unnecessary designation, with risk of this leading firms to withdraw valuable financial services from U.S., reducing availability/increasing cost of remaining services • Creates perception of U.S. as protectionist with regard to financial services

Issue	Intended Impact	Possible Unintended Impact
FRB SIFI Regulation	Ensure rigorous top-tier standards	<ul style="list-style-type: none"> ● Lack of any final FRB standards designed for nonbanks creates prospect for inapplicable rules that add cost, undermine effectiveness
Scope of Financial Services	Cover all nonbank financial companies that may be SIFIs	<ul style="list-style-type: none"> ● Uncertain definition of “financial,” with pending FRB rule casting so broad a net that almost any nonbank may be eligible (e.g., consulting firms)
Transparency	Ensure clear designation criteria	<ul style="list-style-type: none"> ● FSOC standards may permit subjective designation as quantitative criteria are over broad, include numerous factors inapplicable to nonbanks (e.g., simple \$50 billion asset threshold) ● Qualitative criteria subject to varying interpretation ● Lack of ability of possible designees to model, anticipate designation may disrupt operations, add unnecessary cost
Confidentiality	Ensure information provided to FSOC is protected from undue disclosure	<ul style="list-style-type: none"> ● Uncertain confidentiality protection may limit information firms provide to FSOC and lead to ill-informed designation
Cost/Benefit Analysis	Ensure designations meet this criterion	<ul style="list-style-type: none"> ● FSOC indicated cost/benefit analysis done, but did not release ● Results thus uncertain and process may be unduly burdensome

Securities Lending and Repurchase Agreements

The FSB has targeted securities lending and repurchase agreements (repos) for reform as part of its broader effort to monitor and regulate shadow-banking, giving itself until the end of 2012 to issue policy recommendations. In its interim report, the FSB described seven issues with securities lending and repos which could pose systemic risk, including a lack of transparency, the procyclicality of system leverage and interconnectedness, collateral re-use, collateral fire sales, agent-lender practices, cash collateral reinvestment, and weak collateral-valuation and risk-management practices. While global efforts are underway, U.S. policy-makers have pushed for more rapid action, with FRB Gov. Tarullo calling for greater transparency in the bilateral repo market and improvements to the risk management and settlement processes for clearing banks and BHC-dealer affiliates in the tri-party repo market. He also calls for uniform leverage restrictions such as a system of haircut and margin requirements that can be applied to a range of markets, including OTC derivatives, securities lending and repos.

Securities Lending

Issue	Intended Impact	Possible Unintended Impact
Macro-Level Transparency	Improve macro-level market data and risk reporting by intermediaries; enhance regulatory supervision; provide clients with the ability to assess default risk in the market	<ul style="list-style-type: none"> • Conflicting U.S. and global standards leading to confusion/complexity/undue burden
Micro-Level Transparency	Improve micro-level (transactional) market data and risk reporting by intermediaries; enhance regulatory supervision; provide clients with the ability to assess counterparty-credit and collateral risk	<ul style="list-style-type: none"> • Transaction-level data requirements for generally non-standardized securities loans could raise compliance costs with uncertain benefits

Issue	Intended Impact	Possible Unintended Impact
Haircuts on Collateral	Mitigate the procyclicality of leveraged transactions based on the market value of collateral	<ul style="list-style-type: none"> • Mandatory haircuts set at arbitrary levels may reduce discretionary securities-lending activity and, therefore, reduce market liquidity

Repurchase Agreements

Issue	Intended Impact	Possible Unintended Impact
Macro-Level Transparency	Improve macro-level market data and risk reporting by intermediaries; enhance regulatory supervision; provide clients with the ability to assess default risk in the market	<ul style="list-style-type: none"> • Macro-level data may result in useful information about overall market conditions, but data requirements should be balanced against overall costs
Micro-Level Transparency	Improve micro-level (transactional) market data and risk reporting by intermediaries; enhance regulatory supervision; provide clients with the ability to assess counterparty credit risk and collateral risk	<ul style="list-style-type: none"> • Transaction-level data requirements for generally non-standardized repo transactions could raise compliance costs with uncertain benefits
Haircuts on Collateral	Mitigate the procyclicality of leveraged transactions based on the market value of collateral	<ul style="list-style-type: none"> • Unnecessary since collateral haircuts remained stable during the crisis • Minimum haircuts may result in higher government borrowing costs • Incentivizes unsecured borrowing

Collateral Re-Use/Re-Hypothecation	Reduce systemic interconnectedness and leverage	<ul style="list-style-type: none"> • Re-use or re-hypothecation does not diminish collateral protection for market participants • Reduces liquidity in the repo and related cash markets; raises costs for issuers
Collateral Liquidation	Prevent fire sales	<ul style="list-style-type: none"> • Restrictions on repo buyer ability to sell collateral securities of an insolvent seller could result in higher insolvency risk for the buyer

Resolution

Global Systemic-Resolution

In late 2011, the Financial Stability Board (FSB) finalized “key attributes” for the resolution of SIFIs, focusing in particular on banks. Since then, the FSB and its member agencies have worked with national regimes to implement these principles, national regulators through 24 “crisis management groups” to address the resolution of individual cross-border banks. However, the ongoing European Union crisis has made it difficult to address this issue, although a recent summit has now concluded very high-level principles in this area as well as the initial framework for an E.U. deposit-insurance system. The U.K. has, however, instituted a more binding resolution protocol designed to prevent taxpayer support for troubled banks.

Issue	Intended Impact	Possible Unintended Impact
Global SIFI Resolution Principles	Reduce likelihood of systemic risk through cross-border contagion; bar expectation of taxpayer support and end resulting moral hazard	<ul style="list-style-type: none"> • Discontinuities in national resolution regimes make orderly cross-border resolution uncertain • Remaining expectation of taxpayer “bail-out” creates funding-cost differentials, regulatory-arbitrage opportunities with adverse systemic-risk, competitiveness impact
SIFI Coverage	Ensure orderly resolution for all SIFIs, not just banks	<ul style="list-style-type: none"> • Process bank-centric with uncertain integration in existing national resolution regimes for nonbanks (e.g., insurers, broker-dealers) that can create disorderly resolution, competitive disparities, cross-border contagion
SIFI Impact	End TBTF	<ul style="list-style-type: none"> • Inconsistent with pending G-SIB, G-SIFI surcharges based on potential systemic risk of failure, potential “bail-out”

Issue	Intended Impact	Possible Unintended Impact
Resolution Protocols	Preserve maximum amount of going-concern value without bail-out, prevent contagion risk	<ul style="list-style-type: none"> • Uncertain processes for recapitalizing SIFIs through use of bridge entities, tactics to be used for financial-market infrastructure
Implementation	Ensure rapid action by all G-20 nations to ensure orderly cross-border SIFI resolution	<ul style="list-style-type: none"> • Uncertain timeframe, differing approaches and unclear statutory basis for pending resolution initiatives with the possibility of a European banking union adding further uncertainty
Treatment of Foreign Depositors	Ensure orderly resolution with appropriate protection for home-country depositors and protection of deposit insurance fund	<ul style="list-style-type: none"> • Disparate deposit-preference standards create prospect of discriminatory treatment, resulting in a disorderly cross-border resolution
Confidentiality	Protect cross-border information flows to ensure orderly resolution	<ul style="list-style-type: none"> • Varying law threatens protection of confidential examination/business information
Fire Sales	Use SIFI cross-border resolution to prevent systemic risk resulting from asset fire sales	<ul style="list-style-type: none"> • Uncertain procedures for resolution, lack of transparency may promote collective-action problems such as fire sales\
Government Intervention	Ensure government action only at point of non-viability and resulting systemic risk	<ul style="list-style-type: none"> • Differing national “non-viability” standards and possible home/host conflict over resolution creates market uncertainty, could prompt contagion risk
Qualified Financial Contracts (QFCs)	Ensure orderly resolution of complex derivatives, other QFCs	<ul style="list-style-type: none"> • Uncertain cross-border standards creates “temporary stays” to protect counterparties, with inconsistent treatment creating potential for systemic risk, regulatory arbitrage

Issue	Intended Impact	Possible Unintended Impact
Resolution Plans (Living Wills)	Ensure orderly resolution for varying SIFI charters, host-country jurisdictions	<ul style="list-style-type: none"> • Lack of host-country deference to home resolution authority creates plan discontinuities, inconsistencies • Global regulators have yet to agree on single “lead” plan to guide home/host action
Transparency	Orderly resolution as parties anticipate likely governmental action	<ul style="list-style-type: none"> • Lack of participation by private sector may limit actual resolution-regime transparency
Dispute Resolution	Ensure fair treatment of cross-border claims	<ul style="list-style-type: none"> • Lack of clear cross-border judicial rights creates uncertainty, risk of collective-action problem leading to liquidity runs as funds flow to jurisdictions with clear legal protections for creditors, counterparties

Orderly Liquidation Authority

Title II of the Dodd-Frank Act establishes an orderly-liquidation authority, under which failing non-bank financial companies could be resolved by the FDIC to prevent undue disruption akin to that experienced in 2008 when AIG, Lehman Brothers and other nonbanks failed. OLA covers the parent corporations of insured depositories, broker-dealers, state-regulated insurance companies, and any nonbank financial company the failure of which may pose systemic risk. The law requires that OLA only be deployed when a series of findings made by the Treasury Secretary and confirmed by other regulators concludes that resolution under the otherwise applicable insolvency statute would be unduly risky. OLA must track bankruptcy to the greatest extent possible with regard to losses borne by shareholders, creditors and counterparties, with prior management and directors generally subject to penalty. One of the key differences between OLA and bankruptcy is the ability of the FDIC to establish a “bridge” entity through which it can recapitalize subsidiary firms to preserve going-concern value without bailing out shareholders, creditors and/or counterparties. The FDIC has implemented OLA in a series of rulemakings since the passage of Dodd-Frank, and it is now working on additional issues to ensure transparency and a fully-developed OLA process in the event of any systemic concerns. Large banks are also providing the “living wills” required by Dodd-Frank to give the FRB and FDIC the information necessary to avoid use of OLA and, should it be required, to ensure a smooth resolution with minimal market risk or taxpayer/industry cost.

Issue	Intended Impact	Possible Unintended Impact
Global Framework	U.S. rules form part of coherent global resolution framework to handle cross-border institutions	<ul style="list-style-type: none"> • Limited ability to apply OLA outside the U.S. • Financial Stability Board resolution principles not fully implemented • TBTF expectations in other nations, lack of cross-border information, legal consistency hamper cross-border resolution

Issue	Intended Impact	Possible Unintended Impact
Top-Tier Coverage	Use OLA only for U.S. financial firms not covered by other resolution protocols (e.g., FDIC, SIPC, insurance guaranty associations)	<ul style="list-style-type: none"> • Integration of OLA with other protocols uncertain • OLA rules bank-centric and complicate resolution for non-bank subsidiaries/parent companies • Broad FDIC authority may override other resolution schemes and disadvantage beneficiaries (e.g., insurance policy-holders)
Living Wills	Ensure advance planning for orderly resolution through bankruptcy	<ul style="list-style-type: none"> • Lack of resolution plans outside U.S. banking sector may force undue ring-fencing, limits on banks • Public disclosures related to living wills may provide proprietary information that permits “raids” by traders, acquirers destabilizing markets
Cost to Taxpayers	Prevent any cost since systemic firms to be assessed to cover any FDIC OLA expenditure	<ul style="list-style-type: none"> • Post-crisis assessments could strain surviving firms still under stress
Recapitalization	Preserve going-concern value without affording any bail-out	<ul style="list-style-type: none"> • Complex process that, until framework is complete, may be difficult to execute under stress

Issue	Intended Impact	Possible Unintended Impact
OLA Deployment to Nonbanks	Rare use only for firms whose failure is determined to be systemic	<ul style="list-style-type: none"> • Possibly used for nonbank financial companies not previously regulated by FRB, forcing systemic firms (banks and nonbanks) to absorb resolution cost for entity previously outside comparable regulation • Uncertain definition of “financial” could broaden possible number of firms for which OLA is used that were not previously under FRB systemic regulation • Difficult to calculate credit exposures if application of OLA is not known
Compensation Clawback	Punish culpable management	<ul style="list-style-type: none"> • Reach of clawback could discourage qualified managers from joining troubled firm rescue attempt, lead to exodus of critical personnel as firm condition weakens
Creditors	Ensure orderly resolution; recoveries no greater than those in bankruptcy	<ul style="list-style-type: none"> • Uncertain judicial recourse in OLA could complicate resolution • Complexities of determining minimum bankruptcy recovery may lead to more/less recovery • Lack of clear role for creditors’ committees complicates minimum pay-outs
Qualified Financial Contracts	Ensure orderly resolution without undue counterparty protection	<ul style="list-style-type: none"> • Continued uncertainties regarding temporary stay may undermine OLA, create differing incentives from bankruptcy resolution

Large-Bank Deposit Insurance Premiums

The Dodd-Frank Act restructured the manner in which FDIC premiums are assessed, especially for larger banks. Based on the view that overall operations pose risk, premiums are now based on total liabilities held by an insured depository, not the actual amount of deposits being insured by the FDIC. The law also gave the FDIC first authority to redesign the manner in which it measures “risk” for purposes of charging premiums tied to it. The total effect of these changes has been to shift more of the burden of FDIC coverage to the largest banks and create a complex “scorecard” based on FDIC judgments to set risk-based premium assessments. These changes come as most other nations have only limited deposit insurance or none at all, a situation that exacerbated the EU crisis by destabilizing national banking systems, causing liquidity runs and increasing sovereign indebtedness.

Issue	Intended Impact	Possible Unintended Impact
Asset-Based Assessments	Set premiums based on risk to FDIC	<ul style="list-style-type: none"> • Creates incentive for banks to fund through insured deposits, not other sources previously exempt from premiums, thus increasing actual risk to FDIC • Undermines limited role of deposit insurance by charging premiums unrelated to actual FDIC exposure on insured deposits • Reinforces expectation that all depositors will be protected by FDIC, creating “moral hazard”
Funding-Source Risk Assessment	Charge premiums to promote reliance on low-risk, long-term funding	<ul style="list-style-type: none"> • Minimal credit for use of long-term debt may not discourage overall shift to insured deposits and, thus, higher risk to FDIC • Treatment of FHLB advances as risky may undermine stability of FHLB System, reduce mortgage credit availability
Foreign Branches	Charge premiums based on risk of offshore branches	<ul style="list-style-type: none"> • Treating foreign branches as risky discounts liquidity, diversification value of branched operations, promotes subsidiarization with perverse safety-and-soundness consequences

Issue	Intended Impact	Possible Unintended Impact
Custodial Banks	Structure risk-based premiums to reflect special nature of custodial banks	<ul style="list-style-type: none"> • Unduly high premiums still penalize banks with minimal FDIC risk, create competitiveness concerns
Asset Measures	Reflect risk to FDIC	<ul style="list-style-type: none"> • Failure to recognize risk mitigation unnecessarily increases premiums, exacerbates incentives to risk-taking
Burden Shift to Larger Banks	Penalize banks for being “too big to fail” and thus enjoying funding advantages over smaller banks	<ul style="list-style-type: none"> • Dodd-Frank ends TBTF through orderly-liquidation authority • Penalizes large banks which are charged by market for risk of failure and assessed by FDIC as if all exposures, not just insured deposits, protected
Scorecard	Identify risky insured depositories	<ul style="list-style-type: none"> • FDIC models depart from primary regulatory capital ones, charging premiums for sound activities and creating perverse risk-taking incentive
Premium Data	Charge premiums based on comparable, objective data	<ul style="list-style-type: none"> • Lack of current, comparable data (e.g., regarding large counterparties) results in disparate premiums

Housing Finance and Securitization

Securitization Risk Retention

The Dodd-Frank Act requires that securitizers hold at least five percent of the credit risk in assets sold into secondary markets in asset-backed securities (ABS). Several types of ABS are provided potential statutory exemptions, most notably those sold with U.S. Government guarantees such as the Federal Housing Administration (FHA), commercial mortgage-backed securities (CMBS) that meet specified criteria, and residential mortgages that meet “qualified residential mortgage” (QRM) requirements. U.S. regulators have issued a proposal to implement these risk-retention requirements, which build on current FDIC rules that provide a “safe harbor” in bank failures only for assets originated by insured depositories that meet still more stringent requirements. No final risk-retention rule has been issued, although the FDIC has indicated it will conform its safe-harbor requirements to the risk-retention ones once finalized. The E.U. has a five percent risk-retention requirement, although it differs from the U.S. requirement in ways now under review by the International Organization of Securities Commissions in connection with a broader review of global securitization regulation. This comes in concert with Financial Stability Board review of the degree to which securitization creates shadow-banking risk that requires direct regulation and/or limits on banking organizations active in this area.

Issue	Intended Impact	Possible Unintended Impact
Macroeconomic Impact	Ensure prudent credit formation	<ul style="list-style-type: none"> • As much as 50% of total U.S. credit formation depends on ABS, so unduly stringent or unworkable risk retention requirements may choke credit, delay recovery and/or force undue reliance on government securitization channels with added taxpayer risk, lack of market discipline
Global Framework	Ensure comparable ABS regulatory regimes	<ul style="list-style-type: none"> • Divergent standards exacerbate credit-formation problems due to complexity of accessing global investors
Incentive Alignment	Bring securitizer interest in sync with investors/borrowers	<ul style="list-style-type: none"> • Requirement that credit risk be retained over life of ABS (even as it amortizes down to minimal value) may counter incentive alignment

Issue	Intended Impact	Possible Unintended Impact
ABS Coverage	Cover all but government-backed, very sound ABS	<ul style="list-style-type: none"> • Government/GSE exemptions discourage return of private capital; broad scope fails to reflect diversity of ABS and different risk profiles/securitization structures
Nature of Risk Retention	Ensure robust retention and incentive alignment	<ul style="list-style-type: none"> • Proposed approach to premium capture creates punitive impact effectively barring many ABS • Promotes regulatory arbitrage, competitiveness concerns
Risk Retention/Capital Requirements	Coverage by relevant capital standards	<ul style="list-style-type: none"> • Punitive to regulated banks, as risk retention combines with higher capital charges for securitization exposures to create higher capital requirements, reducing incentives to securitize • Relationship between risk-retention/capital requirements in varying proposals left unclear • Likely to drive securitization to securitizers exempt from regulatory capital • Strict limits on mortgages under U.S. Basel III NPRs effectively narrows QM, forcing QRM into still smaller box that exacerbates concerns regarding risk retention
Residential Mortgages	Promote prudent securitization	<ul style="list-style-type: none"> • To the extent that non-QRM securitization becomes prohibitively expensive for issuers, a narrow QRM combined with exemption for the GSEs (while in conservatorship) will likely increase/maintain their dominance of mortgage funding; non-QRM mortgage rates could rise by between 40 to 65 basis points • Residential mortgages now equal approximately total U.S. bank balance sheets, meaning that mortgage credit formation cannot depend solely on bank balance sheets, especially if new, stringent capital requirements are taken into account • QRM specifics (e.g., 20% downpayment) adverse to prudent loans to first-time/low/moderate-income borrowers

Issue	Intended Impact	Possible Unintended Impact
Risk Retention/Safe Harbor Coordination	Uniform regulatory construct	<ul style="list-style-type: none"> • Tighter FDIC “safe harbor” rules encourage origination/securitization through nonbank channels that, if unavailable, restrict credit formation • Promote growth of shadow banking
Economic Analysis	Ensure clear understanding	<ul style="list-style-type: none"> • Lack of transparent economic-impact analyses in conjunction with NPR may lead to unanticipated, adverse impact
Administrative Process	Opportunity for comment, deliberation	<ul style="list-style-type: none"> • NPR includes so many questions that an additional, more definitive proposal is necessary to receive meaningful comment, avoid premature and risky final action

Qualified Mortgage

The Dodd-Frank Act defines qualified mortgages (QMs) as loans that meet an array of criteria designed to ensure long-term ability by borrowers to repay residential mortgages and handle associated homeownership costs. Mortgages that do not meet the QM standards are not barred, but lenders could be subject to significant legal risk if a borrower in fact is unable to pay a non-QM. QMs are a broader class of mortgages than “qualified residential mortgages” which are mortgages exempted from the risk-retention requirements elsewhere in Dodd-Frank applicable to securitizers and, perhaps, originators of residential mortgages. The interplay of the QM and QRM standards will define which mortgages are likely to be originated and securitized, with pending exemptions for certain government loans and/or securitizations creating the possibility for differing standards that reduce private-label mortgage securitization. If QMs are defined more broadly than QRMs, then QMs could be retained on bank portfolios, although new capital standards may affect overall portfolio capacity, as well as bank appetite for specific QMs; non-QMs are likely to be very capital-intensive and, thus, hard either to originate or securitize by banks and BHCs.

Issue	Intended Impact	Possible Unintended Impact
Relation to Capital Standards	Unsure, but both rules create product criteria (possibly different) for prudent loans	<ul style="list-style-type: none"> • Combination of legal risk related to non-QMs and punitive capital charges for them may create effective product prohibitions that discourage loans to first-time/ low/moderate-income borrowers outside U.S. Government/GSE channels • Capital standards may drive securitization to USG/GSEs, increasing taxpayer risk

Issue	Intended Impact	Possible Unintended Impact
QM/QRM Standards	Both provisions aimed at improving mortgage-market stability, consumer protection	<ul style="list-style-type: none"> • Uncertain relationship of standards may constrain private securitization; varying agency jurisdiction over QRM could lead to added confusion • Discontinuities between QM and QRM may limit credit availability unless banks have capital capacity to absorb QMs that do not meet QRM qualifications
Legal Risk	Protect lenders from legal, related risk for QMs	<ul style="list-style-type: none"> • Uncertainty over safe harbor vs. rebuttable presumption makes scope of legal-risk protection unclear • Rebuttable presumption may lack robust protection and lead lenders to avoid all but the most conservative QMs, reducing credit availability (especially for first-time, low/moderate-income borrowers)
Assignee Liability	Ensure that mortgage purchasers (including in MBS) take risk if origination practices deficient	<ul style="list-style-type: none"> • Complex QM could make investor verification uncertain, reduce secondary-market demand/credit availability
QM Definition	Ensure long-term ability to repay	<ul style="list-style-type: none"> • Subjective standards (e.g., net tangible benefit to borrower) may reduce secondary market liquidity for loans
Points and Fees	Protect borrowers from high-cost loans	<ul style="list-style-type: none"> • Complex standards lead to unintentional errors, undue legal risk uncertainty in face of legal risk